

UBS Investment Research

Q-Series®: What is “Integrated Reporting”?

Global

Global Sustainability

Theme Piece

How good disclosure connects to value

■ “Integrated reporting”: A new approach to corporate reporting

“Integrated reporting” (<IR>) is a new approach to corporate reporting, designed to allow investors to make insightful connections between key pieces of information, thereby smoothing the investment process. Evidence of investor interest in shifting the reporting landscape towards a consideration of medium- to long-term issues (such as environmental change) is apparent at the time of writing, in the context of this week’s UN summit on sustainable development in Rio de Janeiro.

■ Our methodology: A broad review of stakeholder opinion

In this report, a response to client interest, we consider the views of representatives from academe, standard-setting, accountancy, consultancy, advocacy, research and portfolio management. We review what leading companies are doing, through a series of case studies, interviews, and consultations with UBS analysts (see Table 1, p5). This work gives us good examples of companies shifting towards <IR>.

■ Context is all in <IR>: Who dares wins

We would expect one of the benefits of <IR> being widely adopted to be improved market efficiency. That said, the effects of shifting to <IR> on individual share prices would likely depend on the context: new information or insight could potentially be positive or negative. For companies moving to <IR>, we believe it may be a case of who dares wins. In this report, we highlight examples of company reports we identify as relatively integrated on our combined views: BASF, Intel, and American Electric Power (AEP). We applaud Puma’s Environmental P&L innovation, while encouraging greater connectivity with the whole.

■ Examples of pure-play companies likely to find integration easier

We highlight the *European ESG Analyser* sustainable stocks: pure-play companies where we can see the connection between the company ethos and the core business in company reports – Colruyt, Kingfisher, Novozymes and Umicore.

20 June 2012

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Prices and data as at 12th June 2012 unless otherwise stated

Executive summary

Integrated reporting: 2+2=5

The concept of “integrated reporting” (<IR>), sometimes also called “one report”, is a new idea, but also an old idea. We are writing about <IR> at this juncture because we perceive a rising tide of client interest in the topic, prompted, perhaps, by market conditions (but going back much further than that – see Chart 1, p8). Finance industry users of company reports read them in order to understand companies better in the context of investment goals. The objective of stakeholders currently working on the <IR> initiative is to improve the quality of company reports from this very pragmatic perspective. From the stance of the investor, what is meant by “quality”?

In essence, good quality reports:

- Make it easy for the user to make insightful connections between key pieces of information in the context of the investment decision-making process.
- Give a clear view of the relevant elements of the firm’s strategy and progress, not forgetting risks and challenges, and how the company is dealing with them.
- Allow long-term unquantifiable risks or opportunities to be taken into account. A good report makes clear how any environmental, social or governance (ESG) issues discussed link to the core strategy.
- Allow business-critical information to be found easily.

What integrated reporting is not

- Doubling or tripling the amount of information in the annual report by adding a lot of new metrics.
- Splicing the sustainability report and the annual report.
- Putting sections of the sustainability report in the annual report.

In a nutshell, <IR> allows report users to ‘join the dots’ in the way that best works for them in the context of return requirements, risk appetite and constraints. <IR> may also deliver other benefits, such as greater market efficiency. What would this mean for investors?

Evidence of investor interest in shifting the reporting landscape towards a consideration of medium- to long-term issues (such as environmental change) is apparent at the time of writing, in the context of this week’s UN summit on sustainable development in Rio de Janeiro¹. In our view, improved market efficiency should, in the long run, lead to lower volatility for the markets where <IR> is successfully delivered, by reducing uncertainty across the wider market. (Large positive or negative surprises would, other things being equal, be less likely.) Other things being equal, the long-run effect of a successful shift to <IR> across the board should be a lower cost of capital. The effects of

Integrated reporting (<IR>) can be seen as another name for good quality reporting

Figure 1: Integrated Reporting



Source: UBS

All else being equal: <IR> = better disclosure = greater market efficiency

¹ <http://www.ft.com/cms/s/0/95098764-b654-11e1-a14a-00144feabdc0.html#axzz1y8WJzPNy>

transitioning for stocks would likely depend on the context: new information could potentially be positive or negative for share prices. In its early stages, <IR> may at first be a case of who dares wins.

Which companies do <IR> best?

The investment question is which companies do the best job of connecting the dots? Since <IR> is a work in progress, we think it likely no company has cracked the idea yet, but many will do so in coming years.

We think companies can currently be put into two groups: simpler, pure-play firms that will find it relatively easy to deliver <IR>; and diversified or larger (and therefore more complex) firms for whom <IR> is much more of a challenge. We explore this challenge in a later section, entitled “What leading companies are doing”, summarised in Table 1 below.

This section of the report contains case studies, interviews, and UBS analyst commentary. As part of this discussion, we run the “UBS one report road test”.

The “road test” is a very simple test of <IR> across a small group of firms. We look to see if it is possible to identify the firm’s strategy easily (on the company website), and to proceed from that point along a narrative that delivers an understanding of how the information in the different company reports connect to each other and to the strategy. As an example, when company strategy statements incorporate an element of sustainability, we look for evidence that a similarly integrated perspective (core business with sustainability) is pursued throughout the reporting structure.

Combining company case studies, the views of UBS’s stock-covering analysts, interviews with company representatives and the road test, we think the following stand out:

- **BASF:** Early adopter of <IR>. Capital allocation based on long-run views.
- **Intel:** Described as delivering “user-friendly” reports by the UBS covering analyst, the sustainability team noted the care taken to connect less-read reports (e.g. the proxy statements) to the core.
- **American Electric Power:** A recognition that the environmental and safety management and culture needed to change was the catalyst for a more integrated approach to reporting, suggesting close alignment within the business and reports.
- **Puma:** It delivered a groundbreaking innovation – the Environmental P&L – that raises the reporting bar, and we look forward to future developments. In particular, we hope for greater granularity.

No company has cracked integrated reporting...yet

The UBS one report road test: Is it easy to find a definition of the company’s strategy, and the key narrative that best explains the key opportunities and risks, and how they connect to the strategy?

Table 1: Summary – what leading companies are doing in the early stages of <IR>

| Company | Finding | Market cap (€m) | Rating | Ccy | Price | Price target | +/-PT | PE adj (x), 2012E | Analyst |
|-----------------------------|--|-----------------|---------|------|---------|--------------|--------|-------------------|-------------------------|
| Akzo Nobel | Interview: Started integrating ESG three years ago. | 8,970 | Sell | € | 37.79 | 36 | -4.72% | 12.1 | Thomas Gilbert |
| American Electric Power Inc | Interview: The need to manage environmental risk was a catalyst for more transparency in reporting. UBS analyst one report road test *: Helpful connections. | 15,358 | Neutral | US\$ | 39.73 | 39 | -1.84% | 13.2 | Jim von Rieseemann |
| BASF SE | Interview: Put financial and sustainability reporting on one platform in 2007. UBS analyst one report road test: Early adopter of integrated reporting. | 51,698 | Neutral | € | 55.96 | 64 | 14.38% | 10.2 | Thomas Gilbert |
| BHP Billiton plc | UBS analyst one report road test: Connectivity between key pieces of information a work in progress. | 124,632 | Buy | £ | 1791.50 | 2400 | 33.97% | 8.4 | Myles Allsop |
| Danone | UBS analyst one report road test: Navigation through reports is not easy, but we note Danone has joined the IIRC pilot. | 31,635 | Buy | € | 51.75 | 59 | 14.01% | 16.3 | Alan Erskine |
| Diageo | UBS analyst one report road test: "One report" is present in spirit much of the time; connections are overtly made. | 49,569 | Buy | £ | 1587.50 | 1700 | 7.09% | 17.2 | Melissa Earlam |
| General Electric Co | UBS analyst one report road test: GE has committed to improving disclosure for Capital Finance over time. | 166,199 | Buy | US\$ | 19.48 | 23 | 18.07% | 12.6 | Jason Feldman |
| Intel Corp | Interview: Working towards increasing connectivity between AR, 10K, proxies and corporate responsibility report. UBS analyst one report road test: "User friendly". | 106,008 | Buy | US\$ | 26.52 | 34 | 28.21% | 9.7 | Uche Orji |
| Lanxess AG | UBS analyst one report road test: Integrated approach to green mobility. | 4,251 | Neutral | € | 50.09 | 66 | 31.76% | 6.6 | Joe Dewhurst |
| Novo Nordisk | Interview: 20th anniversary of triple bottom-line approach coming up. UBS analyst one report road test: Blueprints for change need to be up front – an important reporting innovation. | 61,319 | Neutral | DKr | 808.00 | 875 | 8.29% | 22.4 | Andrew Whitney, PhD, CA |
| PepsiCo Inc | UBS analyst one report road test: Reports are structured, so that connections can be made in different directions to suit the user. | 86,635 | Neutral | US\$ | 68.40 | 66 | -3.51% | 16.8 | Kaamil S Gajrawala |
| Puma SE | Case study: Important innovation – the Environmental P&L. | 3,636 | Neutral | € | 238.95 | 270 | 12.99% | 15.5 | Fred Speirs |
| Rio Tinto Limited | UBS analyst one report road test: The report structure guides the reader through a connected narrative. | 80,295 | Buy | A\$ | 54.65 | 105 | 92.13% | 7.7 | Glyn Lawcock |
| Solvay | UBS analyst one report road test: Solvay could unlock value with greater disclosure on the R&D pipeline. | 7,028 | Buy | € | 84.17 | 135 | 60.39% | 10.0 | Joe Dewhurst |
| Unilever plc | UBS analyst one report road test: Well-chosen data points and connections systematically made. | 73,760 | Neutral | £ | 2055.00 | 2200 | 7.06% | 13.6 | Alan Erskine |

Source: UBS

Note that we do not see this analysis as complete. This should not be read as a ranking of firms. It is exploratory work.

* The UBS one report road test is a very simple test of <IR> across a small group of firms. We look to see if it is possible to identify a firm's strategy easily, and to proceed from that point along a narrative that delivers an understanding of how information in the different company reports connect to each other and to the strategy.

Smaller firms

For smaller pure-play companies, the connection between the company ethos and the core business is likely to be relatively straightforward (other things being equal), and so relatively easily expressed in company reports. Table 2 below details examples of such stocks.

Table 2: Pure plays and *European ESG Analyser* sustainable stocks

| Company | Rationale and report insights | Market cap (€m) | Rating | Ccy | Price | Price target | +/-PT | PE adj (x) 2012E | Analyst |
|---------------|---|-----------------|---------|-----|--------|--------------|---------|------------------|-----------------|
| Colruyt | A listed company self-described as working on the basis of social entrepreneurship. Makes it absolutely clear that employees, shareholders, suppliers, manufacturers, neighbours and family all matter. The company has no debt, a balance-sheet structure we see as consistent with the model. | 4,983 | Sell | € | 31.47 | 26 | -17.38% | 15.3 | Benjamin Peters |
| Kingfisher | Kingfisher aims to "make it easier for customers to have better and more sustainable homes". This connects to the new medium-term plan, as described on the website, featuring cross-group networking and five-year "workstreams" and milestones. | 8,107 | Buy | £ | 274.50 | 350 | 27.50% | 10.2 | Andrew Hughes |
| Novozymes A/S | Global leader in bio-based materials. Environmental performance is integral to the brand, and therefore also to the business model. Life-cycle assessment (LCA) is used to assess the environmental effects of the firm's solutions. | 6,945 | Neutral | DKr | 160.00 | 160 | 0.00% | 27.0 | Joe Dewhurst |
| Umicore | Core: Innovation addressing resource scarcity. Performance metrics given in key areas of human capital and environmental performance. | 4,286 | Buy | € | 38.25 | 51 | 33.33% | 13.1 | Joe Dewhurst |

Source: UBS, *ESG Analyser*, 9 June 2011, and company reports Price and price target related data as at 12/6/2012

These companies happen to be those identified last year as the *European ESG Analyser* sustainable stocks², chosen because we think the core business has a good chance of being consistent with the company value system. We note that, to date, the *ESG Analyser* framework has only been applied to a European universe, and moreover, has not been applied to the full universe of mid-caps covered by UBS. Therefore, this list is inevitably incomplete at this juncture. We aim to work on it further in coming months.

We hope that the above gives a taste of <IR>, the direction of travel and the potential benefits we expect it to bring. Commenting on the summary of the responses to the International Integrated Reporting Council (IIRC) discussion paper, published on 8 June, IIRC CEO Paul Druckman said:

*"What the integrated reporting framework will do for the corporate reporting process is to enable investors and other stakeholders to understand better the ways in which companies create sustainable value"*³

Sustainable value creation

² Julie Hudson CFA, Hubert Jeaneau, *European ESG Analyser*, 9 June 2011.

³ <http://www.theiirc.org/2012/06/08/international-integrated-reporting-framework-on-track-for-publication-in-2013-confirms-iirc/>

What is integrated reporting?

It is useful to begin with the conventional idea that “integrated reporting” indicates a set of company reports that gives a “true and fair” account of company activity. By definition, we believe the “true and fair view” concept cannot help but incorporate sustainability issues when they are material or potentially material to the core business. A set of company reports that does not refer, somewhere, to potential “tail risk” (low-probability, high-impact potential events) in our view could be described as incomplete, & therefore not a “true and fair view” of the firm. Last but not least, the report users need to be able to test the “true & fair view” proposition - best through peer-group comparison.

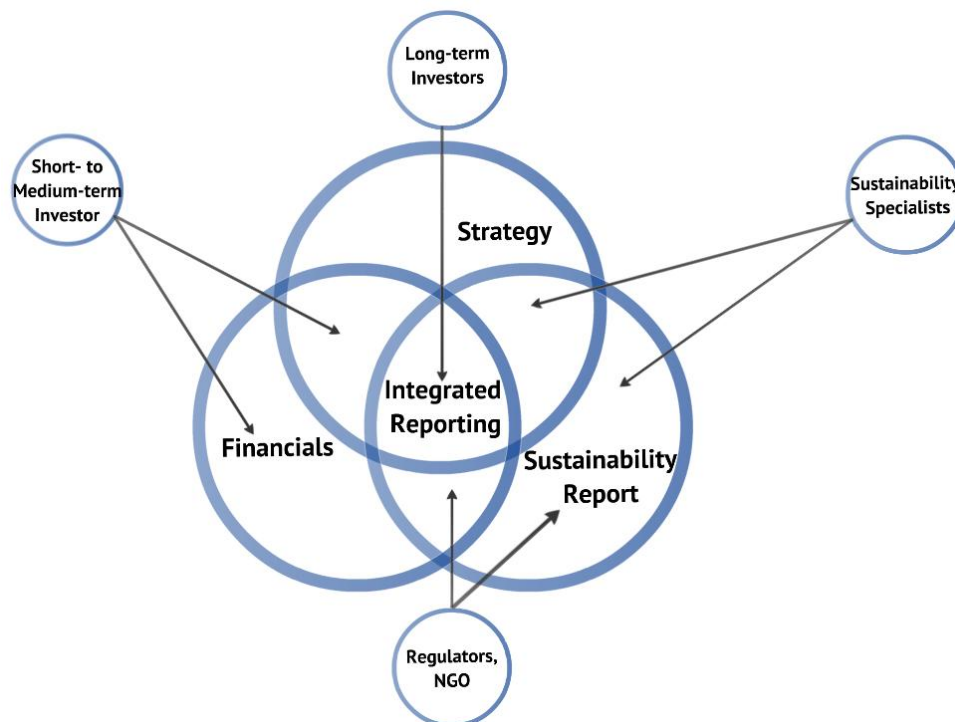
The current discussion envisages a multi-stakeholder report in which the company strategy is the focal point, and technology allows the user to find the information that is relevant to them, with a full understanding of how it relates to the business (see Figure 2 below). What this suggests is that while the specific information needed by individual stakeholders may vary, all information paths must eventually connect, so that the result is (in essence) the same “true and fair view” of the company no matter what the angle of approach.

We stress, at this point, that <IR> is not the same thing as sustainability or ESG (investment that specifically seeks to take environmental, social and governance issues into account). However, a good quality integrated report would bring together all the information that is core to the company strategy, including sustainability issues – at the mid-point in Figure 2. In our view, the conjunction of strategy, financials and sustainability depicted below is what the long-term investor is likely to be looking for.

Integrated reporting: A “true and fair view”, incorporating all information relevant to the core business, readily comparable with peers, and providing insight into potential “tail risk”

<IR> is not the same thing as ESG; <IR> goes far beyond this specialist field

Figure 2: Integrated Reporting – the ‘holy grail’ of corporate reporting



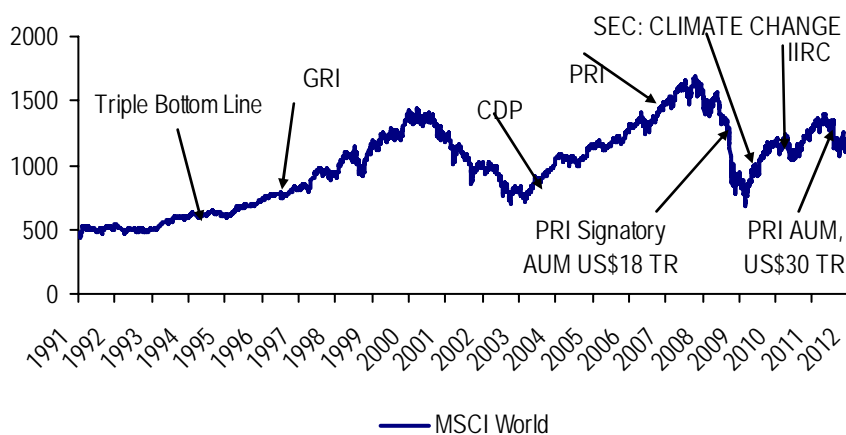
Source: UBS

Apart from this, we would expect different users to focus on the information that corresponds to need. A good integrated report, facilitated by technology, should allow some flexibility of use.

State of play

If the above definition described company reports to the general satisfaction of all concerned, it is unlikely that the drive towards integrated reporting would be as longstanding, or as active, as it is currently (see Chart 1). Looking back, it is clear that new ideas have arrived at intervals over almost two decades, gaining momentum in the credit crunch years.

Chart 1: Integrated reporting – a longstanding issue gaining momentum



The chart suggests the drive towards ESG-related disclosures is gaining momentum. The push towards integrated reporting can be seen as a transition from the initial goal of better disclosure and transparency to greater clarity of reporting on the subject of performance

Source: Thomson Datastream, MSCI, websites as detailed in the footnote

As we write, the concept of “triple bottom line” is roughly 17 years old,⁴ while the Global Reporting Initiative (GRI), now in its third iteration and with more than 3,000 companies profiled on its website,⁵ was created almost 15 years ago by CERES.⁶ It is not quite six years since the Principles for Responsible Investment (PRI) emerged from a gathering of institutional investors called by the United Nations (UN); assets under management (AUM) represented by signatories to the Principles have reportedly grown to US\$30 trillion,⁷ uninterrupted by the credit crunch.⁸ Other initiatives of note include:

- The Carbon Disclosure Project (CDP, created 2003), which reports that more than 3,000 organizations worldwide “now measure and disclose their greenhouse gas emissions”;⁹

⁴ <http://www.johnelkington.com/TBL-elkington-chapter.pdf>

⁵ <http://database.globalreporting.org/>

⁶ <http://www.ceres.org/investor-network/how-we-work-with-investors/disclosure/disclosure>

⁷ <http://www.unpri.org/about/>

⁸ The value of assets under management (AUM) represented by PRI signatories was US\$18 trillion in October 2008 and, as reported in September 2011, was US\$30 trillion. Source: *Financial Times*, 3 November 2008, as cited in UBS’s *Q-Series®: Corporate Governance – CG in the investment process, why and how?* Julie Hudson, 6 November 2008. See UNPRI’s press release dated 7 September 2011 at <http://www.unpri.org/press/2011%20RoP%20press%20release.pdf>.

⁹ <https://www.cdproject.net/en-US/WhatWeDo/Pages/overview.aspx>

- The Securities & Exchange Commission (SEC) decision to make reporting on climate risk mandatory (2010);
- The arrival – also in 2010 – of the International Integrated Reporting Council (IIRC), and in 2011, the Sustainability Accounting Standards Board (SASB).

(Summaries of these initiatives and organizations are provided in the glossary at the back of this report.)

Moreover, a number of regulatory bodies in different countries – for instance, Argentina, Australia, Denmark, Germany, France, Greece, the Netherlands, Spain, India, Malaysia, South Africa, the UK and US – as well as the EU (see Table 11) have legislated on matters that are directly relevant to the field of <IR>.

The momentum behind integrated reporting is clear to see; however, it is not progressing in a straight line. Given the number of projects and initiatives in the field currently, and the long time-frame represented in the above chart, we consider the forces moving for and against integrated reporting.

Forces moving for and against integrated reporting

What is moving things forwards?

We take the view that the 2008 credit crunch and subsequent developments have drawn attention to the risks inherent in taking a narrow view of companies and sectors, and the advantages of taking a more rounded perspective, incorporating linkages and context. Beyond this, we believe that a general awareness of natural resource limits started to accelerate in about 2005 – the year that marked the start of a rapid rise in the profile of climate change in the media, alongside a steady rise in energy prices. Trends in commodity prices through the financial credit crunch brought issues such as food security and resource constraints to the fore. The credit crunch raised the profile of governance as a risk issue, and post-credit crunch economic conditions have put issues such as inequality into the media on a regular basis. All of these affect how firms run their businesses, as well as how they are perceived. Thus, standard annual reports not incorporating such issues can be seen to be incomplete.

We do not view the ascendance of the corporate social responsibility (CSR, also known as CR) report as necessarily the same thing as integrated reporting. However, it is probably right to interpret this trend as symptomatic of a desire for change in company reports in a broader sense. The number of firms reporting on CSR has grown significantly (see, for instance, the number of reporters mentioned on the GRI website). Yet, we believe few firms report in a truly integrated manner, defined as conveying an understanding of what societal issues mean for the core business.

For the long-term investor able to weather short-term volatility, but vulnerable to long-run value destruction in scale, such as that witnessed in the current financial credit crunch, improved disclosure, giving a better understanding of so-called torpedo risk, is invaluable. Value investing, long-term investing and values-based investing are not necessarily the same thing, but in the area of integrated reporting, their interests often converge. The presence of long-term and/or value investors in the mix is supportive of integrated reporting,

The 2008 credit crunch and a general awareness of natural resource limits have helped increase interest in integrated reporting

We believe few firms report CSR in a truly integrated manner

The presence of long-term and/or value investors in the mix is supportive of <IR>, particularly for insights it might provide regarding structurally-driven value destruction

particularly for insights it might provide regarding structurally-driven value destruction (or indeed creation).

Nevertheless, we believe that many firms still put unconventional and conventional issues in separate boxes. Some would say this has always been the case, considering the case of the “extraordinary item” in financial reports. There are volumes of CSR reporting, but little truly “integrated reporting”. The question is what is preventing that from happening?

What is blocking progress?

The most obvious block on progress in the field of integrated reporting is cultural: the perception that non-financial issues or, indeed, anything not on the beaten path of conventional reporting is marginal to the main job of investment decision making. This is not a new problem. Those who experienced the so-called TMT bubble in the late 1990s will remember the divide between equity and credit analysis that may have contributed to the bubble and subsequent difficulties. Currently, those perhaps most aware of the narrow lens of investment analysis are the people who specialise in the fields of sustainability and ESG.

The flip side of this problem is the perception that something is not reported, when in fact it is there, but, for perfectly good reasons from the perspective of the report issuer, is subsumed within other content. In our view, this often reflects philosophical differences between what needs to be reported; analysts based in principles-based and code-based corporate governance regimes are likely to have quite different expectations of company reports. Susanne Stormer (vice president, corporate sustainability, Novo Nordisk), interviewed by UBS in February 2012, commented on her experiences as follows, in a way that reflects both of the above points:

‘I represent the coalition of voices that would like to embed sustainability in mainstream[...]There is criticism that there is less sustainability information reported now. But, in actuality, it’s just more integrated and therefore can’t be distinguished or counted. We are also isolating what counts and matters most’

Beyond this, one of the dangers inherent in advancing to the more all-round perspective on a firm is the proliferation of data that can result from an increase in what is reported on. Large amounts of data serving a disparate set of agendas can generate more heat than light, and can be worse than insufficient disclosure. In short, finding the right balance, so that enough is disclosed to permit a full understanding of the company, without overwhelming the report readers with too much information, is not easy. In essence, this is a process of cultural change.

Legal systems grow from the cultural context. They can be said to hard-wire aspects of the prevailing culture. Novo Nordisk’s Susanne Stormer observed that, when the firm began to report on sustainability, the conventional financial statements were a “legal document” whereas the sustainability report was “full of stories coming seven weeks after the annual report.” To resolve this, a change in company bylaws was required, for, without this, the firm’s accounting function (understandably) put the financial statements first and sustainability second, rather than looking at both in an integrated fashion.

First and foremost, confusion about what to report

Integration = invisibility?

Legal requirements set accounting systems in stone, and this can shape behaviour (says Novo Nordisk), impeding integration

Integrated reporting is more than ESG integration

We emphasize that ESG integration is not the only thing “integrated reporting” is about, even though it happens to provide a useful test of the concept of <IR> because if a company has reached the ‘holy grail’ of the integrated report, ESG integration will also work by definition. Integrated reporting is about communicating a true and fair, all-round view of any given company. The most successful integrated report will convey the identity of the firm quite quickly, and the user should also find it easy to get to critical pieces of information. Twenty-twenty hindsight examples of situations where integrated reporting (and integrated report usage) may have been helpful from an investment perspective include the following:

- Howard Sherman of GMI, recounting the history of GMI’s early-day pilot tests, often recounts his discovery of what he considered to be investment-critical information in Enron’s firm’s proxy statements (key information thus not integrated with the whole).
- On the evidence of the 2000 technology bubble, credit and equity aspects of the corporate balance sheet were generally not analysed by report users in an integrated way. Thus, the build-up of off-balance sheet financing went unnoticed.
- The events of the 2008 credit crunch suggest that the interconnectedness of the build-up of low-quality mortgage finance with bank sector balance sheets went unnoticed. Integrated reporting would have been no guarantee, but might have made an integrated analysis more likely.

ESG integration is not the only thing <IR> is about, even though it happens to provide a useful test of the concept

Integrated reporting should be about helping report users make insightful connections between disparate pieces of information

Themes in selected literature

In this section, we briefly review publications that look at some of the thematic that arise in the context of putting integrated reporting into practice.

Integrated reporting and corporate behaviour

The impact of a corporate culture of sustainability on corporate behaviour and performance – Robert G Eccles, Ioannis Ioannou, and George Serafeim

In this 2011 working paper, the authors ‘investigate the effect of a corporate culture of sustainability on multiple facets of corporate behaviour and performance outcomes’. Their findings include evidence to suggest that ‘high sustainability companies significantly outperform their counterparts over the long term, both in terms of stock market and accounting performance.’¹⁰

Comment

The approach taken in this work depends heavily upon the fullness and quality of corporate disclosures in respect of environmental and social policies adopted over a number of years. It also contains an informative insight into the reporting patterns of companies designated “high sustainability” and those designated “low sustainability” in this work. A key finding is that more of the “high sustainability” companies report on ESG-related information. However, many of them do not, as illustrated by the slides presented during a UBS client conference call at the end of last year. Table 3 below shows one example, presented by Bob Eccles and George Serafeim (drawing on data provided by SAM (Sustainable Asset Management)), in the field of human capital.¹¹

Classifying companies as “high sustainability” and “low sustainability” depends on the completeness and quality of company disclosures

Table 3: Measurement of non-financial information – employees

| Non-financial disclosure | Low sustainability, % disclosing | High sustainability, % disclosing |
|---|----------------------------------|-----------------------------------|
| HR Performance indicators/non-financial | 16.2 | 54.1 |
| KPI labor/EHS fatalities tracking | 26.3 | 77.4 |
| KPI labor/EHS near-miss tracking | 26.3 | 64.5 |
| KPI labor/EHS performance tracking | 89.5 | 95.2 |

Source: Presentation materials as detailed in the footnote. Table based, in turn, on data provided to the authors by SAM.

According to this data, high sustainability firms are significantly more likely than low sustainability firms to report on HR indicators. However, in the sample of 180 companies, c46% of the high sustainability companies (top right) do not report. It is difficult to interpret this number in isolation. It could mean that as time passes, a larger majority of firms will report on such data.

Informative example of different disclosure patterns – human capital

¹⁰ Eccles, Robert G., Ioannou, Ioannis and Serafeim, George, ‘The impact of a corporate culture of sustainability on corporate behavior and performance’ (23 November 2011). *Harvard Business School Working Paper Series 12-035*. Available at SSRN: <http://ssrn.com/abstract=1964011>

¹¹ UBS research Insight Conference Call, Sustainability and financial performance, material prepared by Professor Robert G. Eccles and Assistant Professor George Serafeim, Harvard Business School, 7 December 2011.

An alternative explanation (in light of the discussion under way above) is that a decision has been made by the 46% of high sustainability companies not reporting that such metrics would add no meaningful information. Following this train of thought, it is likely that the information delivered in the financial statements, other reports and disclosures of the non-reporters (the 46%) is enough *in aggregate* to tell the user of the relevant company reports that the companies have a "culture of sustainability". On the other hand, an 89-95% reporting rate could just mean this is a highly regulated information set – and, as such, unlikely to contain much information. (For example, see the discussion of the lost time injury frequency rate conducted during BHP Billiton's recent sell-side analyst breakfast, page 70).

Returning to the comment made above, the challenge for the users of such company information in stock selection is to know which path companies are following:

We believe firms can and do compete on the quality of their disclosure. In principles-based accounting regimes, we believe the best quality disclosure will, by definition, do the best job of integrating ESG issues that are core to the business, assuming a "true and fair view" accounting principle is adhered to. In rules-based systems, in contrast, firms may be more inclined to compete on completeness, which is good news if the rules are designed to deliver all relevant information (and no more), but less good news for users if not.

UBS

Inevitable data gaps and what this means for analysis

Does the stock market fully value intangibles? Employee satisfaction and equity prices – Alex Edmans

This paper explores employee satisfaction as a driver of long-run stock returns, leveraging data collated over a significant number of years by the Great Place to Work Institute (GPTW).¹² The outperformance of the '100 Best Companies to Work for in America' between 1984 and 2009 is the key finding, suggesting as it does that 'employee satisfaction is closely correlated with shareholder returns', and that 'the stock market does not fully value intangibles.'¹³

Comment

The data used by Alex Edmans to write his article is significant in this context, for it is incomplete. The data underlying the rankings is not universally available for all firms for it was not all disclosed in the context of a conventional accounting framework. Some of the data is based on survey responses released to the GPTW Institute by company employees, by agreement with the company, but in confidence from company management.¹⁴ Not only is the survey data

Integrated reporting could look (superficially speaking) incomplete, yet still give the user enough information to make a call

Human capital – associated with strong performance in this important study

The data in this study is incomplete and unavailable in the public domain – and yet can still be used in a powerful way on this evidence

¹² Alex Edmans, *Does the stock market fully value intangibles? Employee satisfaction and equity prices*, *Journal of Financial Economics*, Volume 101, Issue 3, September 2011, Pages 621-640

¹³ Cited with the permission of ScienceDirect, from the abstract at <http://www.sciencedirect.com/science/article/pii/S0304405X11000869>

¹⁴ <http://www.greatplacetowork.co.uk/best-workplaces/apply-now/how-youre-evaluated>

disclosed to the GPTW Institute by employees not in the public domain, but only the top 100 rankings are released but not those below that level.¹⁵

At first glance such partial disclosure seems to have little to do with integrated reporting. However, from the perspective of the company, what happens to the survey data – it is jointly analysed with publicly available accounting data to produce the rankings – can be seen as a very good example of integrated reporting in action. We believe it likely that quite a few companies in the top 100 fall into the group of firms described by Bob Eccles as embracing a “corporate culture of sustainability”. The question is, does it matter that most investment analysts would be unable to replicate this work for other companies – after all, the all-important employee survey data is unlikely ever to be publicly available for analysts to apply an analogous approach to a significant number of listed firms?

We would proffer that as long as analysts have access to enough information to suggest that the company is, internally speaking, operating in a fully integrated way, the need for integrated reporting is met. However, the writer confesses to residing in a principles-based regime (the UK), and consequently, has a preference for principles-based (rather than rules-based) regimes, believing that when it comes to integrated reporting, less is likely to be more.

Corporate governance to shape the <IR> regime

The social responsibility of the investment profession – Research Foundation of CFA Institute, Julie Hudson CFA, August 2006

The CFA Institute Research Foundation monograph, written in 2006 by UBS, observes that ‘the “culture” of the accounting system in any given country is likely to have been shaped by local institutions, such as the political and legal systems, and the ‘structure of finance systems’. Thus, ‘the accounting system is likely to have been most significantly influenced by whether the prevailing legal regime’ is based on a common law or civil code approach. Additionally, the nature of the prevailing capital market structure (whether market-driven, bank-led or block-holder dominated) will inevitably shape the structure of reporting systems.¹⁶ This is considered important in the context of <IR>.

Comment

In our view, the prevailing accounting culture in any given region will shape the integrated reporting debate. In a principles-based system, we see the onus as being on the firms reporting on environmental, social and governance issues to identify what is material in an accounting sense, with the aim of giving a true and fair view of the business. In a rules-based system, the onus is, in contrast, on the relevant accounting or regulatory body to get the rules right. We believe it likely that companies will respond differently to the two regimes.

From a company perspective, the joint analysis of internal survey data with publicly available accounting data can be seen as a very good example of <IR> in action

Integrated reporting is not incompatible with apparently incomplete reporting. What analysts need is enough information to assess the quality the business model

The <IR> debate will be shaped by the local accounting culture. Therefore, different regions may have markedly different views regarding the “how to”

Principles-based and rules-based accounting regimes will have a different “take” on the matter

¹⁵ <http://www.greatplacetowork.com/best-companies/100-best-companies-to-work-for>

¹⁶ The social responsibility of the investment profession, Julie Hudson CFA (Research Foundation of CFA Institute, July 2006) found at <http://www.cfapubs.org/toc/rfi/2006/2006/3>. See p. 22. See also chapter four for further detail. Cited with permission.

We believe it likely that firms compete (p. 22) to put an optimal information set into the public domain, taking into account the likely impact of such information and direct disclosure costs. Consequently, we believe there is scope for firms to compete on the quality of their disclosure in principles-based regimes, and the best quality disclosure will, by definition, do the best job of integrating ESG issues that are core to the business in the context of the “true and fair view” principle. In rules-based systems, in contrast, firms may be more inclined to compete on completeness, which is good news if the rules are designed to deliver all relevant information (and no more), but bad news if not. The risk, in the context of rules-based approaches, is an overload of potentially irrelevant information, as well as a lack of transparency when rules are many and complex.

We would also expect investors located in principles-based or rules-based reporting regimes to differ in terms of their information demands, posing a potential challenge for international companies operating in both contexts, and indeed for international accounting bodies, seeking to design accounting rules to suit both.

On paper, we think principles-based systems are more likely to produce a “true and fair view” of the business, defined as full integration of *all relevant information* (including relevant ESG disclosures). However, we also think both systems can lead to conflicts of interest, the most obvious being pressure to disclose information that will help the share price in the short run, or to mask information that may be negative. Neither system can protect the users of company reports against this problem.¹⁷

Principles-based systems potentially facilitate competition to report what is relevant to a “true and fair view”; rules-based systems drive competition to report fully in compliance with the rules

Shareholder demands may also vary by region; this explains the sometimes confusing information demands companies encounter

On paper, <IR> is more likely in a principles-based accounting context, although conflicts of interest can get in the way in any accounting culture

¹⁷ Note that we are not referring to accounting fraud, but to differences in presentation. In theory, the substance of accounting information (and not the form it is presented in) should be what affects share prices. We believe that form, as well as substance, can affect share prices. For example, the widely-anticipated change to accounting for leases in the UK should theoretically not have affected valuation, and yet, because the P&L and balance sheet are affected in form (even though not in substance), we believed it would do so. (See European Small and Midcaps, *Impact of capitalising operating leases*, Marcus Baeumer, Alex Hugh, Dennis Jullens, Bosco Ojeda, 13 September 2010).

Views from practitioners and other stakeholders

In this section, we consider the views of selected representatives from the fields of academe, standard-setting, accountancy and reporting framework architecture, as well as the views of financial services consultants, advocates, specialist research organisations, and portfolio management practitioners. We do so by reviewing some of the reports of the relevant organisations, as well as interviewing their representatives. Interviews did not all follow the same pattern, but a question set often used (and sometimes replicated in full with the responses) was as follows:

- What (in a nutshell) do you MOST want to see in an “integrated report” defined as a company report that effectively integrates ESG?
- How do you define an integrated report, and what are the primary differences from conventional reporting?
- Who benefits from integrated reporting? Who is potentially at a disadvantage?
- How do you think integrated reporting might change the behaviour or decision making of companies? Investors? Others?
- Who is determining the new standard for reporting? Who is participating? Who is missing from the dialogue?
- Who (what kind of organisation) is opposed to integrated reporting and why? What do you think the response should be, and from whom?
- What do you expect might be the timeline for the arrival of integrated reporting?

Academe

Robert G Eccles, Harvard

Professor of Management Practice, Harvard Business School

A number of the different stakeholders we spoke to in the writing of this report talked about HBS professor Bob Eccles’ concept of “one report”. We found agreement, “chapter and verse”, and we also encountered concerns (“too much information!”). As a preliminary to presenting key points from our interview with him, we think it useful to refer to the two meanings of the term “one report”, presented in the book appropriately entitled *One report*.¹⁸

- “One report” means reporting through the medium of a single document. This document serves to let all stakeholders (whether shareholders, employees, customers or NGOs) know that the company takes an all-round view of the business.
- The broader aim of “one report” is to report financial and non-financial information in such a way that it is possible for the user to see how these aspects of the business interact with each other, and what impact they have on each other.

The provision of “one report” as defined above is made possible by using the internet “to provide integrated reporting in a way that cannot be done on paper”. It permits different stakeholders to start at the same point, that is, the single document that represents the core of the business, and to go from there to the specifics that interest the users in a coherent, connected fashion. The importance of this idea – a shift away from “tramline” reporting of financials on the one hand and the corporate social responsibility (CSR) report on the other – is not to be underestimated, in our view.

Professor Eccles¹⁹ took the opportunity of his interview with UBS to provide some structure to the common concerns raised about integrated reporting and his responses to them. He buckets them as questions of: (1) precedence; (2) risk; (3) cost; and (4) investor demand. Table 4 below summarizes the debate as framed by Professor Eccles with a few additions from our other conversations.

Eccles and Krzus’s definition of “one report”

A single document presenting the business in the round

The interaction of financial and non-financial information presented in a meaningful way for the user

Integrated reporting: Moving from the two-dimensional to the multi-dimensional...thanks to the internet

UBS interview – Eccles takes an overview of concerns

¹⁸ Robert G. Eccles and Michael P. Krzus. *One report: Integrated reporting for a sustainable strategy* (Hoboken (NJ): John Wiley, 2010). See pp. 10-11.

¹⁹ Interviewed by phone on 22 February 2012

Table 4: Summary of debate

| | Concern | Response |
|-----------------|---|---|
| Precedence | Integrated reporting reduces the transparency of ESG information. Years of progress in sustainability reporting could be lost if replaced by a reduced section in an investor-focused, legal document, which may not even be in the terms needed for sustainability people. | Integrated reporting is not just one annual report. The point is not to have only one official document, but for reporting to be “living”, and pervade across many forms of media and communication from the company. There is still a place for conventional sustainability reporting. |
| | There are no frameworks or accounting standards, and so companies are not clear on what they need to do. How will they know if they have done it right? | Yes, a framework needs to be developed. In order to regulate based on reality and practicality, companies will need to experiment and gain experience in trying to integrate. |
| Risk | This is just one more liability to be sued over as raising expectations on ESG metrics just sets companies up for failure and disappointment. Once they start providing this information, they will not be able to stop. | True. Companies are not rewarded for their transparency, but for their performance. This is not a commitment that can be backed off from. That said, it can be done incrementally in small steps. |
| | Companies who release this information will be at a competitive disadvantage and their stock price will be negatively impacted. | That could be right. But a company concerned about disclosing its performance could be a red flag. Further, when accounting standards and the SEC were formed, companies were likewise nervous about reporting financial data, but no one would dispute it today. |
| Cost | Integrated reporting is too costly. It increases liability and control systems that are required to make sure of its quality. It increases the hassle within the company. | If the metrics are material, then management needs them and should have them for its own purposes. These are resources well spent. |
| Investor demand | Companies do not see a need for this type of reporting, as they already provide quarterly calls as a venue. Analysts do not ask about ESG. | Indeed, just putting a report out there does not have much benefit. Companies need to do their part to educate investors by talking about the link between financial and non-financial information. |

Source: Interviews conducted in February and March 2012 as discussed in the text.

In further support of his responses, Professor Eccles also cited a few examples from his own research. With respect to concerns regarding the format and legal nature of the integrated report, Professor Eccles assures that companies should still have flexibility, as evidenced by Novo Nordisk. It chose to integrate into one “official” annual report (which is discussed in a later section), whereas Southwest Airlines opted for an interactive online “one report” (also available in PDF format) separate from its annual report.

Companies can actually find it cheaper and more straightforward to write a single report. In fact, Professor Eccles highlights that an integrated report is meant to be better for managers. Further, he understands that there are only so many requirements the business community can handle (particularly with Sarbanes-Oxley regulation), and so less material things will need to be “taken off the plate” for ESG-factor reporting to work the way that it is intended. The leadership must come from the corporate community since, after all, they are the reporting entities.

Professor Eccles also raises the issue of integrated assurance, which is not as often cited as it probably should be. This happens to be the topic of his latest book chapter, *Integrated reporting requires integrated assurance*,²⁰ where the authors state: “We believe that the full value of integrated reporting will only be realized when integrated assurance is provided on the report.” In other words, in order to rely and compare integrated reports, investors must know that they were verified by a third party according to some agreed-upon, consistent standards. Today, although 44% of sustainability reports in Spain have an assurance opinion, only 6% in the US have one.

²⁰ Written with co-authors Mike Krzus and Liv Watson for *Effective auditing for corporates: Key developments in practice and procedures* published by Bloomsbury Publishing plc in March 2012.

Mick Blowfield, Oxford

Head of Private-sector Transformation, Smith School of Enterprise and the Environment, Oxford University²¹

What (in a nutshell) do you MOST want to see in an "integrated report" defined as a company report that effectively integrates ESG?

I would most like to see a methodical approach that shows the issues addressed are the ones most relevant to the company from a materiality perspective and a stakeholder perspective. Continuity of content (so that I can compare performance year on year) and imaginative ways of dealing with the wealth of sustainability-relevant information that isn't readily quantifiable would also be very valuable.

How do you define an integrated report, and what are the primary differences from conventional reporting?

An integrated report deals with externalities. It takes into account social, economic, environmental and financial dimensions that the company is affected by and/or responsible for. It should give a true sense of the full value of the company once social and environmental dimensions are taken into account.

Who benefits from integrated reporting? Who is potentially at a disadvantage?

I would hope that management across the company would benefit (and to that end, might prefer more effort put into management accounting than external reporting, at least early on). The various parts of the investment community will only benefit once they are convinced that sustainability is a reliable indicator of value, but once they reach that stage, integrated reporting becomes important for them as well. I would also hope that it would help government policy.

How do you think integrated reporting might change behaviour or decision making of companies? Investors? Others?

If done rigorously, it will give a different slant to the value and performance of the company, and that, in turn, ought to change behaviour and decision making, so that the company is aligned with its own interests.

Who is determining the new standard for reporting? Who is participating? Who is missing from the dialogue?

Lots of people are claiming this space – GRI, CERES, all of the accounting giants, accounting bodies, UNPRI, Accountability, CDP and so on. My impression is that engagement from the financial community is sporadic, and blows hot and cold. The ISO crowd are also there in different ways, wanting to keep hold of international standards. Arguably, the most effective ones are very focused – for instance, CDP has probably had more impact than GRI.

²¹ Interviewed by email on 21 February 2012. Recent publication: *Corporate responsibility* (Oxford: OUP, 2011). See: <http://www.smithschool.ox.ac.uk/smith-school-fellow-wins-chartered-management-institute-award/>

Who (what kind of organisation) is opposed to integrated reporting and why? What do you think the response should be, and from whom?

Conventional accountants are often against integrated reporting because they don't think it can be done. Lots of conventional economists don't like the idea of sustainability as a management issue. This is the same for some industry groups, such as the US Chamber of Commerce, in my view.²² There are some strong geographical splits with big differences between North America and Europe.²³ I haven't heard a consistent message from analysts, although my sense is that they don't oppose it, but doubt if the tools can be developed to make it happen.

What do you expect might be the timeline for the arrival of integrated reporting?

It's hard to say. ESG reporting (eg, under a CSR guise) has grown rapidly over 10 years even though the legal requirements are uneven and not onerous. However, big issues are still missing, and despite the plethora of reports, they didn't pick up on the economic meltdown, and they aren't recognising a lot of the key material sustainability issues. I think integrated reporting will have to be driven from the demand side if it is to become rigorous rather than simply widespread, but fluffy.

Integrated reporting will have to be driven from the demand side if it is to become rigorous rather than simply widespread, but fluffy

²² Mick referred to the following example: <http://www.washingtonpost.com/wp-dyn/content/article/2009/10/05/AR2009100502744.html>

²³ <http://www.kpmg.com/PT/pt/IssuesAndInsights/Documents/corporate-responsibility2011.pdf>

Standard-setters

International Integrated Reporting Council (IIRC)

Consulting with various stakeholders in the context of this report, the IIRC²⁴ emerged, time and time again, as the leading protagonist in the integrated reporting debate. The IIRC’s consultation paper, *Towards Integrated Reporting: Communicating Value in the 21st Century*, seems to us to have had a significant impact in three respects:

- The committee driving the report, which brings together a wide range of stakeholders and interested parties, is acting as an effective link between the “traditional” standard-setters and auditors, and ESG specialists in standards, reporting and assurance.²⁵
- The report has extended the integrated reporting network around the IIRC hub by means of the consultation questions, which elicited a significant number of responses (see below). The pilot project is likely to have a similar impact.
- The consultation paper itself offers some useful definitions and a rationale for integrated reporting in the two summary pages at the beginning of the report. These pages are proving to be an efficient sound-board for discussion and debate.

Respondents to our own survey who gave us their definition of “integrated reporting” quite often echoed the IIRC definitions. The IIRC defines integrated reporting as follows:

Integrated reporting brings together material information about an organization’s strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates. It provides a clear and concise representation of how an organization demonstrates stewardship and how it creates and sustains value. An Integrated Report should be an organization’s primary reporting vehicle.

IIRC: Strategy, governance, performance and prospects

The rationale for integrated reporting as described by the IIRC is, in our view, likely to make sense to a wide range of investors, whether generalists or ESG specialists. We note that issues such as “globalization”, “actual and prospective resource scarcity”, “population growth”, “environmental concerns” and “response to financial and other crises” regularly appear in UBS’s macro (mainstream) research as a matter of course.

²⁴ The IIRC was formed by the Prince’s Accounting for Sustainability Project (A4S) and the Global Reporting Initiative (GRI).
http://www.princeofwales.gov.uk/mediacentre/pressreleases/the_prince_s_accounting_for_sustainability_project_695809414.html

²⁵ The IIRC is well qualified to do this because it is “an international cross-section of leaders from the corporate, investment, accounting, securities, regulatory, academic, civil society and standard-setting sectors”. (IIRC Consultation, p.3).

The “building blocks” (the “principles” and the “key content elements”) described in the summary also often popped up as items on the investor wish-list in our stakeholder interviews.

- **The “principles”:** Strategic focus; connectivity of information; future orientation; responsiveness and stakeholder inclusiveness; conciseness, reliability and materiality.
- **“Key content elements”:** Organizational overview and business model; operating context, including risks and opportunities; strategic objectives and strategies to achieve those objectives; governance and remuneration; performance; and future outlook.

The 60 participants in the pilot programmes (registered and on the website list as of 14 March) are distributed as shown below, in terms of sector and country. We note the dominance of accounting firms (10), financials (8) and utilities (5) in the “disclosed” list from a sector perspective. From a country perspective, Dutch (11) and UK (9) firms come top of the list. The presence of nine firms from emerging markets (Brazil (2), South Africa (2), the Russian Federation (2), Chile (1), China (1) and Sri Lanka (1)) is suggestive of the potential global reach of this framework, in our view.

[IIRC pilot – potential global reach](#)

Table 5: IIRC pilot study – participation by country and sector (as at 28 March 2012)

| Sector | Firms | % Total | Country | Firms | % Total |
|-------------------------------------|-------|---------|----------------|-------|---------|
| Accounting | 10 | 15% | Netherlands | 12 | 18% |
| Banks | 5 | 8% | United Kingdom | 10 | 15% |
| Electricity | 5 | 8% | Italy | 6 | 9% |
| Financial services | 5 | 8% | Spain | 5 | 8% |
| Software & computer services | 3 | 5% | United States | 5 | 8% |
| Support services | 3 | 5% | Australia | 3 | 5% |
| Chemicals | 2 | 3% | Germany | 3 | 5% |
| General retailers | 2 | 3% | Japan | 3 | 5% |
| Oil & gas producers | 2 | 3% | South Africa | 3 | 5% |
| Personal goods | 2 | 3% | Brazil | 2 | 3% |
| Pharmaceuticals & biotechnology | 2 | 3% | Denmark | 2 | 3% |
| Transportation services | 2 | 3% | Russia | 2 | 3% |
| Alternative energy | 1 | 2% | Belgium | 1 | 2% |
| Automobiles | 1 | 2% | Canada | 1 | 2% |
| Beverages | 1 | 2% | Chile | 1 | 2% |
| Construction & materials | 1 | 2% | China | 1 | 2% |
| Food producers | 1 | 2% | France | 1 | 2% |
| Food retail | 1 | 2% | India | 1 | 2% |
| Forestry, wood and boards | 1 | 2% | New Zealand | 1 | 2% |
| Gas, water & multiutilities | 1 | 2% | Sri Lanka | 1 | 2% |
| Health care | 1 | 2% | Sweden | 1 | 2% |
| Household goods & home construction | 1 | 2% | Switzerland | 1 | 2% |
| Industrial engineering | 1 | 2% | Total | 66 | 100% |

Source: IIRC Website. <http://www.theiirc.org/about/pilot-programme/> (24 of 36 sectors shown or 54/66 entities. All countries (66 entities) shown).

Interview – IIRC CEO Paul Druckman

The core of our discussion is presented in the diagram below.²⁶ The key point for Paul Druckman is that integrated reporting is about decluttering. The way to declutter is to have the report driven entirely by the strategy of the firm. So as an example, the integrated reports of Coke and Pepsi could look completely different because – although the firms are in the same industry – they have different strategies. The question is what the core of a meaningful company report, incorporating all of the relevant “capitals”, should look like, and the answer will not necessarily be the same from one company to the next. This would be the case even when underlying reports – statutory reports such as the annual report, the 10K, or voluntary reports such as the sustainability report – may have elements in common.

The way to de-clutter is to have the report driven entirely by the strategy of the firm

²⁶ Interviewed on 14 March 2012

The idea behind integrated reporting is to provide investors (who are not all doing the same thing) with a meaningful lens through which to look at the business. Whether the report user is “mainstream” or “sustainability” or “climate change” focused – or indeed a regulator, an auditor, or an NGO – they need to be able to connect the specific report content they may be interested in with the company strategy, as shown in Figure 3. (This diagram inspired the UBS “one report road test” in which we started from the stated strategy and travelled from there through the annual report and other reports to see if a clear all-round narrative was present). No matter who the user is, if the information is not contextualised, it is unlikely to mean much. With this in mind, we believe it important that integrated reporting be flexibly defined, thus allowing a company to tell its story without being constrained by a fixed format.

Integrated reporting should provide investors (who are not all doing the same thing) with a meaningful lens through which to look at the business

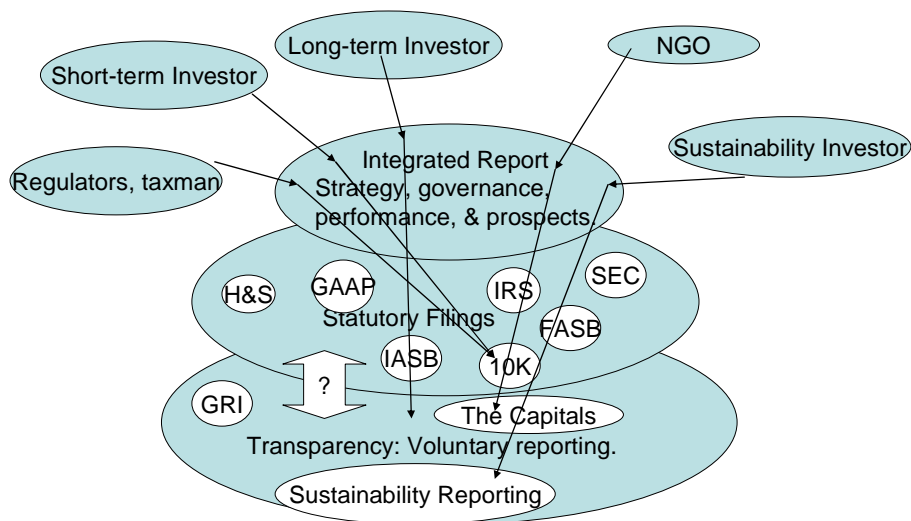
Paul referred to a perception that what integrated reporting is doing is to bring environmental and social issues into the mainstream accounts (diagram, two-way block arrow). Not so, in our view. This is best described as “combination”, which is not the same as integration.

What integrated reporting (<IR>) is not

- <IR> ≠ Adding selected ESG metrics to the annual report
- <IR> ≠ Combining the sustainability report and the annual report
- <IR> ≠ Indexing GRI metrics mentioned in the annual report
- <IR> ≠ Adding one or two pages on sustainability to a company powerpoint.
- <IR> ≠ Requiring a full set of new metrics to be added to conventional financial statements, thereby doubling or tripling the volume of information (and the workload for auditors).

However, some of the above would not be inappropriate if they were core to an understanding of the firm’s strategy, governance, performance and prospects as discussed in the core of the integrated report.

Figure 3: How an optimally designed integrated report should work (yes, it’s complicated)



The Integrated Report provides a lens through which investors and other users can find the relevant material information about the organization’s strategy, governance, performance and prospects, in a way that connects to report-user goals.

Source: IIRC interview, UBS. Loosely based on a whiteboard diagram drawn by Paul Druckman.

IIRC – update on progress

Paul kindly described recent developments.

Pilot study

As of 14 March 2012, 65 firms were signed up to the pilot study (versus 60 in the above table). The IIRC is making efforts to ensure that emerging countries are represented, and is reaching out actively to China, Korea, Brazil and so on. Tata was the most recent joiner as we spoke.

Consultation

The total of 214 responses to the consultation document was above expectations, and the tone of the responses was generally supportive of and positive about the idea of integrated reporting. Only about five of the responses disagreed with the general idea of integrated reporting. All respondents took the trouble to raise questions or challenges, suggesting a significant level of engagement with the issue. These questions and challenges fell mainly into four areas.

214 responses and a significant level of engagement

- In respect of the report section on “business model and value creation”, many respondents asked what was meant by value creation, and for whom it was created. The question many seem to be seeking to address is whether “value” is financial value, social value or some combination of the two.
- The consultation document states that “integrated reports will meet the needs of a broad range of stakeholders.” Initially, however, the IIRC intends to focus the development of the framework on the needs of investors (providers of debt and equity). Some respondents took issue

with this initial focus; however, the consensus was that the investor is an important protagonist in the field.

- Many respondents challenged or discussed the definition of “integrated reporting”. The general feedback from the consultation was that clarity was needed with respect to the <IR> definition, and that the discussion paper did not give that clarity.
 - The IIRC had envisaged the publication of an exposure draft (ED) by end 2012. The feedback from experienced standard-setters was that this is overly ambitious. This problem has been addressed by breaking the framework into components to be released through 2012. A ‘prototype’ is now expected by the end of 2012 and a framework by the end of 2013.
- **Stop press:** As we were finalising this report, the IIRC confirmed that the International Integrated Reporting Framework is on track for publication in 2013.²⁷ Paul Druckman commented: “It is right that companies’ communication with investors and other stakeholders reflects the full range of factors that contribute to the creation of sustainable value.”

Institute of Chartered Accountants (ICAEW)

Brian Singleton-Green – Manager, Corporate Reporting, and Nigel Sleigh-Johnson, Head of Financial Reporting Faculty

UBS met Nigel Sleigh-Johnson and Brian Singleton-Green,²⁸ who described the ICAEW as very supportive of the IIRC initiative. Notwithstanding the challenges of persuading investors that integrated reporting would put significant new investment information on the table, our interviewees felt that the initiative had gained a huge amount of goodwill. They expected the IIRC pilot programme (which started in October 2011 – also see above)²⁹ to be a future source of relevant information.

Key questions at this early stage of development include the following:

- Is a sufficiently wide group of investors involved in the thinking process?
- Investors appear to think primarily in terms of cash – raising the question, is sustainability-related information actually used in investment decision-making?
- How well would the proposed framework function for emerging markets (given the dominance of developed market stakeholders in the Council)?
- One aim seems to be to leverage the reporting function as a means of changing behaviour – is this a case of the tail wagging the dog?

²⁷ <http://www.theiirc.org/2012/06/08/international-integrated-reporting-framework-on-track-for-publication-in-2013-confirms-iirc/>

²⁸ Interviewed on 7 March 2012

²⁹ <http://www.theiirc.org/about/pilot-programme/>

An important issue for the ICAEW is the lack of definition in respect of the term “value creation”. The question is value for whom? This term could refer to private sector P&L, to the government sector, to the social value created by the not-for-profit entity, or some combination.

Definitional issues – what is “value creation” and who is it for?

The ICAEW also pointed out that reporting frameworks are an evolving institution. The need for experimentation before the final framework is tied down was emphasized. In their response to the IIRC, the ICAEW also stressed that the integrated reporting framework should not be mandatory, on the basis that this could create as many problems as it resolves.

Last but not least, it is worth noting that efforts to get corporate reporting right have a long history punctuated by calls for a general restructuring in the context of financial crises. “Business reporting has to change to reflect changes in business, in information technology, and in users’ needs” as principal authors Brian Singleton-Green and Robert Hodgkinson say in their report *Developments in New Reporting Models. Information for Better Markets Initiative*.³⁰ They note that some of the calls for reform in the aftermath of the financial crisis “focus on financial reporting, while others call for extensive non-financial disclosures [and others] demand less complexity in reporting.” (p. 2)

The authors urge that the forces that shape reporting be kept under “critical review” to avoid “excessive or misguided” regulation, or “defective” legal frameworks that fail to get the balance right between “liability problems” and communication (p. vii).

International Accounting Standards Board (IASB)

We believe the IASB has the potential to be a key player in the context of integrated reporting because this organisation has long experience in implementing a common international standard across regional and cultural borders.

Interview with Steve Cooper

IASB Board, and former Head of Valuation and Accounting, UBS Equity Research

How is “integrated reporting” defined, from your perspective?

Integrated reporting is a simple extension of financial reporting. This is clear if you consider the IASB framework, which sets out by asking two questions: What is the objective of the report? Who is the user of the report? These questions are also relevant in the field of sustainability and ESG.

A conventional financial report is about things that the providers of capital (equity or debt) need to know to make informed decisions. A financial report will provide information about revenues, assets, profit, dividends, risk and so on, and this is where most analysts spend 95% of their time. An integrated report would widen the scope of what is reported (the report objective changes) and

An integrated report would widen the scope of what is reported (the report objective changes) and who reads it

³⁰Brian Singleton-Green and Robert Hodgkinson, *Developments in New Reporting Models. Information for Better Markets Initiative* Found on the ICAEW website at the following link:

[http://www.icaew.com/-/media/Files/Technical/Financial-](http://www.icaew.com/-/media/Files/Technical/Financial-reporting/Information%20for%20better%20markets/IFBM/Developments%20in%20new%20reporting%20models.aspx)

[reporting/Information%20for%20better%20markets/IFBM/Developments%20in%20new%20reporting%20models.aspx](http://www.icaew.com/-/media/Files/Technical/Financial-reporting/Information%20for%20better%20markets/IFBM/Developments%20in%20new%20reporting%20models.aspx)

who reads it. The wider the stakeholder constituency – going beyond investors to the general public, or the workforce – the more likely it becomes that their interests will diverge. So, the harder it becomes to define the “what”.

Materiality causes a lot of debate in ESG circles. How do you define it?

From a financial perspective, the acid test of “materiality” is whether the information disclosed would affect an investment decision. If something is not “material” then whether it is disclosed or not disclosed would make no difference. When the stakeholder pool with an interest in company reports widens, this changes the meaning of the word “materiality”. “Materiality” in the context of an investment decision driven by traditional financial criteria is not the same as “materiality” from the perspective of those in the wider pool. However, there is an overlap. So, for instance, if an environmental issue becomes relevant to operational risk, then it may also become material from a financial perspective.

In short, materiality is closely connected to risk?

Yes – and actually risk reporting is one of the most challenging areas for the IASB. It is very hard to define clearly in any case. This makes setting a workable standard for so-called “non-financial” risk really pretty difficult. However, a key point is if “extra-financial” risk is viewed solely from the perspective of shareholders, it will not necessarily result in the reporting of all relevant information, from the perspective of the stakeholders other than the shareholders. In other words, if you confine yourself to the shareholder perspective in designing the standard, the standard might not be fit for purpose.

How do you deal with different accounting cultures?

The varied historical background encountered in different countries or regions can give rise to significant obstacles when you’re trying to harmonize everything as one global standard. To give an example we encounter in the work of the IASB, in some countries – such as Germany – cash is key to profit recognition. In the UK, in contrast, recognising a change in value as P&L is more readily accepted. These profoundly different approaches to profit recognition will inevitably influence disclosure quite differently.

We also find, from our global perspective, that emerging or recently-emerged countries have a real advantage over incumbents with well-established reporting systems. So, for instance, we’ve heard that South Africa is leading the way worldwide on integrated reporting. In the context of the work of the IASB, we find that African, Latin American and Asian countries are far more ready to accept the idea of global standards, whereas those with long-established accounting frameworks tend to push back.

Do you have a view on who gains and who loses, from a potential shift to integrated reporting?

I think society as a whole is likely to gain, but no particular group would necessarily be favoured. I can’t see why there would be losers – although of course there would be the immediate cost of reporting.

Who should do the standard-setting for integrated reporting?

Actually, no single body is well placed to do this job as things stand. What you need is an organisation that has no axe to grind, and also has the credibility of a long-established conventional standard-setter. There is no global body that springs to mind – for instance the UN has the global reach, but does not have the skill-set of a standard-setter. An organisation such as the IASB has global reach, and is a standard-setter, but does not have the capacity or indeed the expertise to take on a significant job like this.

As there is no such global body, one solution could be to work regionally through bodies such as the SEC in the USA, the European Commission, and the FSA (Japan). This would have the advantage of flexing to different regional cultures. This is the approach the IASB has taken with the Management Commentary section of financial statements – this is not mandatory, allowing regional practice to vary between countries that publish a Management Statement as routine and those that do not.

One solution could be to work regionally through existing bodies

When do you think we’ll be able to say we’ve arrived, in the field of integrated reporting?

It’s hard to say – but the number of firms listed as producing some sort of sustainability report seems to be rising. The question is whether those reports are truly integrated. As we discussed, the acid test from our perspective is whether what is provided would make any difference to the person who is using the report.

Global Reporting Initiative (GRI)

GRI (closely connected with the IIRC)³¹ describes its mission as “to make sustainability reporting standard practice for all organisations”. Integrated reporting as defined on the GRI website denotes “the application of the collective mind of those charged with governance, and the ability of management to monitor, manage and communicate the full complexity of the value creation process, and how this contributes to success over time.”³² This could be seen as a slightly longer articulation of the idea of a “true and fair view” concept discussed above, but it spells out the potential challenge embedded in the idea of the “true and fair view” – and this is what can or cannot be read between the lines in the context of complexity. This definition thus captures the idea that a standardised list of KPIs or metrics is unlikely to capture what really matters.

GRI mission: “To make sustainability reporting standard practice for all organisations”

³¹ Ernst Ligteringen, Chief Executive of the Global Reporting Initiative, is on the IIRC Board

³² The GRI citing the International Integrated Reporting Council (IIRC) in an article entitled “Integrated Reporting” found at the following link. <https://www.globalreporting.org/information/current-priorities/integrated-reporting/Pages/default.aspx>

Interview with Dr Nelmara Arbex

Deputy Chief Executive, Global Reporting Initiative (GRI).

What do you most want to see in an "integrated report" defined as a company report that effectively integrates ESG?

An integrated report should express the entire value created (or destroyed) by the organization, should present the main drivers of the business, and key aspects of strategy, along with the sustainability issues that are linked to the strategy. What really makes the link is integrated thinking. By definition, if a company doesn't know how sustainability issues link to strategy, integrated reporting is impossible.

Integrated thinking is the key

How do you define an integrated report, and what are the primary differences from conventional reporting?

What we need is an understanding of what drives value. A conventional set of financial statements cannot do that alone, and the sustainability perspective, similarly, cannot do that either. The question is how a company report can be a good all-round expression of value creation. At the moment, what is most needed is an agreement on the definition of an "integrated report". International dialogue has just started to reconcile a mosaic of different perspectives around an internationally accepted concept.

A properly integrated report would be a powerful expression of value creation

The idea of expressing the entire value created by an organization by improving current financial reporting practice is a dangerous one. If we want a tool that truly expresses value creation we will have to start from a more robust point than our not always reliable financial (or sustainability) reports.

A well designed corporate strategy should address corporate issues and societal issues simultaneously, and both dimensions will run through implementation. Killing two birds with one stone in this manner ensures that shareholder concerns will be addressed. This is because a properly integrated report will be a powerful expression of value creation.

Who benefits from integrated reporting? Who is potentially at a disadvantage?

Business, shareholders and society will all benefit. It is hard to see anyone who might lose through this initiative. However, assuming integrated reporting works as it should, it should help differentiate between likely medium- to long-term winners and losers.

How might integrated reporting change the behaviour or decision-making of companies? Investors? Others?

The collection of information in the context of integrated reporting should involve many areas of the business and should also potentially interpret the contribution of all such areas of the business to value creation in a totally new way. The learning curve starts here, and can and does lead to behavioural change. So, I would say the reporting process (such as sustainability reporting) changes companies – this is a two-way street.

Who is determining the new standard for reporting? Who is participating? Who is missing from the dialogue?

The IIRC is at the core, along with business representatives, sustainability related organizations like the GRI, accountants and auditors.

The answer to “who is missing” is a difficult one, because who the stakeholders in integrated reporting and the IIRC are is still an ongoing international discussion.

Who (what kind of organisation) is opposed to integrated reporting and why? What do you think the response should be, and from whom?

Some companies and some accounting bodies seem to be fully against it because they appear to see it as an unnecessary burden on reporting organizations, with a very weak value proposition so far. Legislators are questioning exactly what the IIRC will propose and are waiting to know more.

What might be the timeline for the arrival of integrated reporting?

A definition is likely to be proposed by the end of the year. The framework itself might take longer to sort out. However, one thing to note is that 331 companies (Source: GRI Sustainability Disclosure Database, 5 April 2012) self-assess as publishing an “integrated report”. This is a 76% increase from 2009. This suggests that quite a lot of experimentation is going on behind the scenes.

Sustainability Accounting Standards Board (SASB)

Jean Rogers, Executive Director and founder

The view of SASB is not dissimilar from that of the IIRC in that an integrated report must have an integrated representation of financial and non-financial performance. A notable difference from conventional reporting, as highlighted by founder Jean Rogers³³, is that ESG factors can be measured in non-financial units and yet they are still material and have the potential to impact valuation and strategic direction for the firm.

ESG factors can be measured in non-financial units and yet they are still material

Integrated reporting also differs from sustainability reporting because it motivates those companies that are “performance-driven” and not necessarily brand-conscious: “Largely, what they’ve seen from sustainability reporting is brand value and customer relationships, but not as much performance improvements, i.e. revenue generation or cost savings.” It is this effect that SASB is counting on in “deriving indicators from actionable business metrics” so that, by tracking and focusing on them, “companies will see performance benefits, by definition.” The goal, according to Jean, is to provide companies with tangible factors which will drive positive outcomes. In some cases, companies are “embracing integrated reporting, even if they are not leaders in sustainability. The reason is that the KPIs resonate with them – they like the fact that they are tied to business strategy.”

³³ Interviewed on 7th February 2012

Comparability is needed for investors

As such, Jean also articulates the incremental benefit for investors, as this is something sustainability reports alone cannot always supply: “Sustainability reports are not about performance or ranking within an industry, but this is exactly what we need. Sustainability reports are great for unique stories, and there is still a place for them, but we cannot invest without comparable data.” Jean has been surprised by the contingent of the sustainability community who have resisted the trend towards integrated reporting – at times, vehemently. However, she feels the fears for the loss of traditional sustainability reporting is unnecessary because, “Sustainability stories and performance data are akin to annual reports and the Form 10-K – they are completely complementary. Both are needed.”

Additional benefits that accrue to investors with integrated reporting include the expectation that “the rising tide lifts all boats” and will improve their portfolio-wide risk management and increase the long-term value of their investments. “Transparency allows for effective management of capital – ALL forms of capital... Transparency could potentially prevent systemic issues industry-wide, such as the recent mortgage crisis.” Further, should the SEC acknowledge the materiality findings of the SASB, thereby requiring ESG reporting via annual 10-K filings, this would make the data freely available to investors, allowing them to expend their efforts on analysis, rather than mere data collection.

In fact, Jean acknowledges that we already have a good idea of what is material, and we have many examples to illustrate it, but what has not been done yet is the codification. “We are not really recreating anything here. Everyone is already doing the measuring and the analyzing, but we need a standard to all follow – it would spare us all some time and effort! Complete, comparable datasets that are accessible to all investors means alpha won’t be derived from information asymmetry, but rather, from interpreting performance and investing with an eye towards future positioning and potential for sustainable value creation.”

UK independent regulator

The UK Financial Reporting Council

We did not interview the FRC,³⁴ but its work is clearly relevant to the field of integrated reporting, on the basis that this body is responsible “for promoting high quality corporate governance and reporting to foster investment”. We note that the FRC submitted a response to the IIRC consultation in which a “keen interest in improving the quality of corporate reporting” is referred to.³⁵

Looking further back, a key question raised by the FRC’s 2009 analysis of a random sample of 50 companies’ annual reports is whether <IR> will add to the already existing trend of longer and more complex financial reports.³⁶ That disclosing extra-financial information can be positive and support the information needs of long-term investors is not questioned. This view also seems to be the spirit of the enhanced business review requirements of the UK Companies Act of 2006. In this act, the business review encourages directors to provide meaningful strategic, forward-looking information, and as a part of that, to communicate on environmental, social and employee factors when relevant.

Considering risk statements and CSR reports, the FRC identified sustainability reporting as a major source of “clutter” in financial reports (along with risk statements). For the FRC, this potentially contributes to information overload, reflected in the trend towards lengthier and more complex annual reports. The FRC notes that around 20% of the 50 companies reviewed had a CSR section longer than their financial review. On the other hand, only 20% provided a convincing explanation of why CSR is important to their business, which highlights the need for connectivity between ESG and the financials in annual reports.

The pressure to be exhaustive may be a major obstacle to the relevance of CSR reporting, according to the FRC. This pressure results in companies reporting on many issues that are not central to their business (e.g. giving chocolate to the community at Easter).

Can this be fixed through regulation? In its answer to the EU consultation on integrated reporting,³⁷ the UK Accounting Standards Board (ASB) indicates it supports a voluntary framework on integrated reporting but not a mandatory one. Based on its experience the ASB states that in the area of reporting “the more detailed the rules, the more boilerplate the answers”.

FRC identified sustainability reporting as a major source of “clutter” in financial reports

Wants to avoid the pressure to be exhaustive, and to see a focus on issues central to the business

³⁴ <http://www.frc.org.uk/about/>

³⁵ <http://www.theiirc.org/wp-content/uploads/2012/02/FRC-UK.pdf>

³⁶

<http://www.frc.org.uk/images/uploaded/documents/Full%20results%20of%20a%20Review%20of%20narrative%20reporting11.pdf>

³⁷ EU public consultation on Disclosure of Non-financial Information by Companies: Response of UK Accounting Standards Board (ASB) – 21 January 2011

Financial services consultants

PwC

Jessica Fries – Director, Corporate Reporting, Sustainability and Climate Change³⁸

How do you define integrated reporting?

The IIRC defines integrated reporting as follows: “Integrated reporting brings together the material information about an organization’s strategy, governance, performance and prospects in a way that reflects the commercial, social and environmental context within which it operates. It is intended to provide a clear and concise representation of how an organization creates value, now and in the future.”

This broad definition received significant support in the IIRC’s recent consultation paper, but it remains an area of debate. One major question is the concept of “an integrated report” (sometimes referred to as one report) versus “integrated reporting”. They are not quite the same thing. For me, the starting point is a focus on integrated reporting, and how an organisation can bring together a broader set of information to give greater insight into strategy and risk, both internally to drive decisions and externally communicating to different stakeholders. This goes beyond the confines of a single report.

A key aspect of integrated reporting is more strategic reporting. At present, the UK government is looking at the idea of a strategy report becoming the main report and a “compliance” document requiring a minimum level of more detailed disclosure in an online format. This has potential to be a step towards integrated reporting. In other parts of the world, moves are also being made towards integrated reporting. Many regulators have set up integrated reporting task forces and some countries – in particular South Africa where integrated reporting is already mandatory – are well ahead. However, not all ESG disclosures made by companies in these countries are truly “integrated”. The linkage between the information disclosed and the core business is absolutely key.

A key enabler to move away from the concept of one report will be changing technology. You are starting to see a shift away from a paper-based world to web-based reporting. As technologies evolve, integrated reporting will become much easier. It will mean that companies can present a core information set, with different levels to allow different report users to go more deeply into areas that specifically interest them and link information provided in one area of the report to that presented in another. From the perspective of the user, this will help bring to life connections between performance in one area and that in another, and highlight much more clearly alignment or lack thereof.

Who benefits? Who is potentially at a disadvantage?

If integrated reporting is done in the right way judged on relevance, there are benefits across the board. Integrated reporting has the potential to deliver the broader, more relevant and strategic set of information many are after, driving

A key question is the concept of “an integrated report” versus “integrated reporting”

More strategic reporting – a key aspect of integrated reporting

Integrated reporting will become much easier as technologies evolve

³⁸ Interviewed on 23 February 2012

longer-term decision-making. It can also reflect the connection between the company and the broader commercial, social and environmental context within which it operates. On the other hand, some fear that integrated reporting risks leading to a reduction in the information currently provided through standalone sustainability reports, particularly if companies move towards preparing an integrated report and stop disclosing additional sustainability information.

For investors, there are quite a few potential benefits frequently cited: more relevant information, greater quality and robustness, improved comparability and more insight into future performance. In addition, by involving the financial reporting community as well as the ESG reporting community, integrated reporting can help accelerate adoption.

For most companies, integrated reporting is a journey. If you look at the experience of the IIRC’s pilot programme, which has more than 70 organisations participating, the initial benefits from integrated reporting are internal – an ability to break down internal silos within the organisation, rethink the strategy and what is material to the company, and align KPIs used with that strategy. Based on the experience of these early movers, the process of integrated reporting can be quite transformative.

Integrated reporting is a journey for most companies

How could integrated reporting change behaviour?

PwC has done quite a bit of research in this area, focusing on how companies drive shifts in internal decision-making. Where changes to reporting are aligned to strategy, and fall clearly into the “risk and opportunity” space, changes to reporting practices can act as a two-edged sword, providing insight as well as shaping behaviour.

However, if reporting is mainly compliance driven, it is unlikely to fulfil either function – it neither provides insight nor shapes the business by influencing behaviour.

The ideal scenario is a feedback loop where discussion with report users, such as investors and regulators, provides insight to the reporting firm, allowing ownership/stewardship to function effectively.

An IIRC pilot project suggests that very often the driver of changes to reporting practices is about improving internal decision-making. When this is the case, “green-washing” is avoided.

Beyond this, thinking about what financial information is not useful, as well as what extra-financial information needs to be enhanced or added, is important. The emphasis needs to be on what matters rather than on what is easy to collate. What is the impact of information reported then not used? This applies across the board, to financial statements, ESG, health and safety, and so on.

Who is determining the new standard for reporting?

The IIRC brings together a wide range of stakeholders and organisations. It has good representation from the financial reporting community, including the chairmen of the IASB and IOSCO (International Organization of Securities Commissions), as well as involvement from the IOSCO and FSB (Federation of Small Businesses). It also has good representation from the sustainability

reporting community, including the GRI. In terms of developing the integrated reporting framework, the pilot programme involves more than 70 companies and 20 investors, to bring practical insight and experience. These groups are also well represented on the IIRC.

To support the development of integrated reporting, it will be important to develop more robust sustainability metrics – something that organisations such as the GRI is focused on. In the US, SASB has recently been formed with the intention of focusing on a small number of key metrics, looking primarily at what is material on a sector basis, and with a focus on the US. This could be an important way of accelerating take-up, but there does need to be more clarity around how the various different groups fit together; at the moment, there is some confusion and that can be an impediment to progress

Who is opposing integrated reporting?

There is no real opposition, but the next two years may be an important test case. Two years ago in a Harvard workshop there was a lot of nervousness – the “juggernaut of financial reporting” was contrasted with the under-resourced teams working on sustainability disclosures. However, integrated reporting can help to rebalance resourcing needs by demonstrating the critical importance of ESG information to the business.

Timelines?

There has been a huge amount of progress in the past two years, and an amazing level of awareness and interest created in such a short time. The next two years will be equally critical, moving from high level concepts to the development of the more detailed framework. During this time, I think we will see experimentation by leading companies, which will help inspire and transform the thinking of others. Most companies already moving towards integrated reporting recognise that they cannot get to their end-point overnight; it takes time to put in place the systems and build understanding across the business. I also see some countries moving quickly towards regulation while others are likely to move much more slowly. We might be looking at a 10-year time frame for integration to be standard across the world – and even that might be optimistic.

KPMG

Wim Bartels, Partner, Global Head Sustainability Assurance

In a recent survey conducted by KPMG³⁹, it was found that of the largest global 250 companies (based on Fortune’s list), 27% report on corporate responsibility in their annual reports (overall, 95% report on sustainability). Of those, 12% discuss it in the director’s report, 62% only in a separate section of the annual report, and 26% in the director’s report and in a separate section of the annual

³⁹ KPMG International Survey of Corporate Responsibility Reporting 2011, KPMG International

report.⁴⁰ These results lend themselves to the question of whether companies should be providing integrated versus combined sustainability reporting.

Wim Bartels⁴¹ of KPMG in the Netherlands told UBS: “The difference is that integration occurs when the approach to strategy and performance is integrated for financial as well as non-financial factors, including sustainability, therefore they are reported as integrated. There is no right or wrong way to do it, but evidence shows combining of sustainability reporting with ‘normal’ annual reporting is a stepping-stone towards integrated reporting.” In fact, Bartels has seen a number of his clients (largely multinationals based out of Central Europe) find themselves moving along a continuum towards integrated reporting, each in their own way. “The approach at KPMG is that sustainable assurance is a constant, continuous journey on the basis of a company’s reporting. The attitude is not just to sign off at the end of the day, but to look to next steps – where can the company improve, what should it do next. We see our role as progressing a company’s reporting on the basis of independent observations during the assurance project.”

Those responsible for sustainability at Bartels’ client firms have been reporting on sustainability for quite some time, albeit in an unregulated way, but this means they have something to contribute and already have some systems in place to deliver to the financial reporting and auditing crowd, making this a natural entry point for integrated reporting. As an auditor, of course Bartels’ priority is accuracy, but he admits that this might not be critical to investors: “Some might say we don’t care if it’s accurate; we only care about the trend over time. In fact, an investor might not look at absolute figures but instead at relative improvement, such as if one company improves on all metrics versus another on a few metrics. From this, they can deduce the attitude of the company. This doesn’t mean we shouldn’t get to the standard, but it means there are other approaches to interpreting and concluding in a meaningful way on the basis of information provided.”

Bartels expresses his main concern as being companies solely issuing one report and nothing more: “They have an integrated report, but this is not the same as integrated reporting, with ‘ing’ at the end.” In choosing a single report strategy, a company could be losing some of its “communication value and strength,” particularly for those stakeholders not accustomed to reading or understanding annual reports, such as employees, consumers, or suppliers. Bartels encourages companies to find ways “to reach their own audiences” to make sure all are informed properly and have the information they would like to see, whether by internet, mail, or the press.

As for the timing of the implementation of integrated reporting, Bartels – being linked to the IIRC pilot – is hearing about the first attempts and first results, but is “not sure we’ll get to integrated reporting in the first round, which is not surprising or wrong.” He suspects that after two to three cycles the IIRC will see

Main concern would be companies issuing just one report and nothing more

⁴⁰ Data from presentation slides by Wim Bartels of KPMG found at: http://www.csreurope.org/data/files/enterprise2020/Communicating_CSR/Wim_Bartels_KPMG_Integrated_reportin_g_trends.pdf, accessed March 2012.

⁴¹ Interviewed on 5 March 2012

what it is hoping for, and then it will be a few years before all leading companies pick up the practice. Other companies first have to actually start reporting on corporate responsibility, and then they can move through the same continuum.

Deloitte

Eric Hespenheide, Global Leader for Climate Change and Sustainability in Deloitte’s Audit and Enterprise Risk Services practice, and member of the IIRC Working Group

In his interview with UBS, Eric Hespenheide⁴² discussed three key issues that come into play for companies considering integrated reporting: multiple stakeholders, tracking of non-monetary data, and data comparability.

Like others who were interviewed by UBS, Hespenheide feels that, “Integrated reporting is a process, not a product.” Precisely for that reason, companies need to avoid the common trap of “focusing only on individual stakeholders, because that would imply that each is equally important. A broader range of stakeholders are influencing how companies create and sustain value. The choice of key stakeholders is part science, part art. Based on our research we suggest that identifying key stakeholders and key issues needs to be balanced in a more rigorous manner so that managers can prioritize which issues are most material to the company. Companies, ourselves included, need to evaluate quantitative and qualitative information, as it pertains to value creation.” That is the essence of “materiality” determination.⁴³

Companies need to recognize that they have multiple stakeholders to respond to, not just shareholders. Hespenheide gives the example of his own company. “Here at Deloitte, why do we collect our own greenhouse gas emissions data? Because our clients ask us to – we recommend them to do it, so they expect the same of us. However, a single manufacturing facility emits more than Scopes 1 through 3 of all of Deloitte. It’s not material for us in the grand scheme of things, but at the same time, we don’t want to be perceived as part of the problem and so we lead by example.”

That said, he does not suggest that companies need to disclose all possible data to everyone; it should be chosen carefully: “The focus should be on what companies use to create value.” He explains further that the current focus in corporate reporting on monetary quantification as a proxy for a company’s performance is inadequate: “There are some material things that are not currently reflected in the financials.” Companies also need to be collecting and tracking data to “allow management to observe non-monetary factors as part of the business.” The hypothetical example Hespenheide uses is a large company with a small office on the island of Fiji – “does that mean we will not collect revenues, because it is not material? No, but that same reasoning is used for ESG. Maybe the company is not going to launch a multi-million dollar implementation at the Fiji office, but we still have to collect the data.” Failure to

A process, not a product

Multiple stakeholders, not just shareholders

“There are some material things that are not currently reflected in the financials”

⁴² Interviewed on 5 March 2012

⁴³ See also recent report from Deloitte on materiality: *Disclosure of long-term business value: What matters?*, available at <http://www.deloitte.com/us/esgmateriality>

do so would result in an incomplete report of how a company conducts its business.

Similarly, to be useful, that data needs to be made comparable, yet there is a clear lack of the ESG equivalent to financial standards, particularly from the perspective of an auditor. "Applying the same measurement techniques can derive meaningful comparisons. Without it, the information is only qualitative and more about how we 'feel' about the decision. That's okay too, but we cannot sift through thousands of companies' information to compare them. We need something to crunch! Standards provide consistent KPIs." Diving deeper into what these KPIs might – or should – look like, Hesperheide has already explained that the financial metrics only tell part of the story, but his additional insight is that, "Pure ESG metrics aren't right either." This may sound surprising, but in fact ties back to the issue of true integration. "How do we get down to the meaningful metrics of not just revenues or costs, nor just kilowatts of use, but kilowatts of efficient and sustainable use, such that the business will continue to survive and thrive for the foreseeable future?" We believe this is a subtle, but non-trivial distinction at the crux of the integrated reporting challenge.

Advocates

CERES

Mindy Lubber – President of CERES and Director of INCR, IIRC member⁴⁴

What (in a nutshell) do you MOST want to see in an "integrated report" defined as a company report that effectively integrates ESG?

What is most needed is a broadly-based recognition that there is no separation between sustainability and finance. Efforts to improve disclosure over the past two decades were primarily about disclosure and transparency. Now, it's about performance. Sustainability is absolutely integral to shareholder value. It is a material issue. It is a fiduciary issue.

How do you define an integrated report, and what are the primary differences from conventional reporting?

There should be no difference between an "integrated" report and a "financial" report. (An integrated report will include data and a narrative that addresses a broader range of issues – including the financial impacts of climate change, of water usage, of fair labour practices, and so on. In today's economic climate, investors and business leaders recognize a broader range of economic drivers that are driving shareholder value). Let's stop calling ESG issues extra-financial issues!

There are plenty of examples to demonstrate the real costs of environmental risk. In the context of the floods in Thailand in 2011, for instance, Lloyd's of London recently warned that the cost would be about US\$2.2bn. In essence, companies need to make it easier for the report users to see which issues are material to the core business.

Who benefits from integrated reporting? Who is potentially at a disadvantage?

All benefit from integrated reporting. However, if it's not done right, all will lose. If we end up with nothing more than a "stapling together" of a sustainability report and the usual financial report, everyone will lose, because this will potentially leave us with more content but less information than we started with.

Avoid the risk of more content, less information

How might integrated reporting change the behaviour or decision-making of companies? Investors? Others?

Sustainability reporting has already changed behaviour. "What gets measured gets managed" and what gets managed changes behaviour. Regulation introduced over the years in the fields of carbon, water, other environmental laws, and safety regulations have engaged entire firms, and elevated such issues to a higher level in many firms.

In the longer run, the specific behavioural change to look for is the inclusion of sustainability issues in earnings calls with analysts.

⁴⁴ Interviewed on 7 March 2012

Who is determining the new standard for reporting? Who is participating? Who is missing from the dialogue?

The IIRC seems to me to be leading the way. This organisation has succeeded in bringing together a wide range of stakeholders, and hundreds of comments have been submitted in response to the discussion paper.

Who (what kind of organisation) is opposed to integrated reporting and why? What should the response be, and from whom?

As yet there is no opposition – but this may come as the ideas develop. The fact is, the time has come for integrated reporting – of course it will take time for the final shape to emerge.

What might be the timeline for the arrival of integrated reporting?

We’re looking at a three- to five-year development period, in my view.

US SIF

Alya Kayal, Director of Policy and Programs

In November 2011, US SIF (The Forum for Sustainable and Responsible Investment) submitted a letter⁴⁵ to the International Integrated Reporting Committee in response to a request for comment on the IIRC’s discussion paper (described above). US SIF⁴⁶ represents a membership of firms, institutions and individual financial professionals engaged in sustainable and responsible investing – who are perhaps most likely to be utilizing sustainability reports and ESG information.

Although the letter assures that “we support your efforts for an integrated reporting framework with both financial and environmental, social and governance (ESG) information”, it also expresses a concern that it “would actually prefer to see a separate and comprehensive ESG report published rather than a much shorter ESG section of an integrated report.” The organization has supported efforts to integrate ESG information into annual reports and has submitted comments and petitions to the US Securities and Exchange Commission (SEC) on ESG disclosure. US SIF is opposed to the reduction or removal of important ESG information, but supportive of a range of reporting options that will increase the quality of information provided to investors and others.

In discussing the letter with UBS, Director of Policy and Programs Alya Kayal⁴⁷ noted that US SIF wants to make sure that standards are high. “As an investor organization, we are pushing for reporting and disclosure that is as robust as possible. We need to aim high in order to end up with a good result.”

US SIF wants to make sure that standards are high

US SIF provides a few other suggestions in its letter, including that IIRC should not rely completely on management to determine what is most material, as it may not match up with what investors or others stakeholders would choose. It

⁴⁵ http://ussif.org/resources/factsheets_resources/documents/SUBMISSIONTOIIRC-FINALVERSION.pdf or <http://www.theiirc.org/wp-content/uploads/2012/02/US-SIF-USA.pdf>

⁴⁶ <http://ussif.org/>

⁴⁷ Interviewed on 14 March 2012

also suggests that IIRC correct the perceived imbalance of accountancy firms that seem to be more actively represented as well as acknowledge existing work done by GRI.

What was not specifically mentioned in the letter, but which Kayal discussed in her interview, is that although US SIF represents its sustainable and responsible investment members, it is also very much willing to "bring in the crowd" of investors who are just beginning to think about sustainable investing. In fact, excluding them would be in direct opposition to US SIF's concern about the partiality of the IIRC. "Obviously, SRI investors have led the way and have done this for years. But we are wary of always preaching to the choir. It is important to get feedback from the "mainstream" and from large firms... This is a great opportunity to bring them up to speed."

Very willing to "bring in the crowd" of investors who are just beginning to think about sustainable investing

Specialist research

GMI⁴⁸

Kimberly Gladman, CFA, PhD – Director of Research and Risk Analytics, GMI Ratings⁴⁹

What (in a nutshell) do you MOST want to see in an "integrated report" defined as a company report that effectively integrates ESG?

The thing I most wish for is an approach to reporting in which environmental and social issues are considered in the context of the core business. This should be done in such a way that the ESG issues reported on are clearly connected to the business – a good integrated report will articulate this. What we most need is quality and consistency. What we least need is boilerplating.

Connect ESG issues to the core business – no boilerplating!

However, I would love to see more consistency in reporting. What do I mean by that?

- At the most basic level items required by the 10K in conventional reporting are broadly speaking comparable, and you know pretty much where to find them. We need something like this for ESG issues; however, I do recognise GAAP took a long time to develop!
- Beyond this there needs to be a proper logic to what is reported. Reporting great safety numbers doesn't mean much if the death rate is going up, as an example.

How do you define an integrated report, and what are the primary differences from conventional reporting?

As above, point one.

What the report user needs to know is the following: what are the core issues for the company; how the company understands them from the perspective of the business; and their external impacts. Mega-companies need to go beyond the merely material because something that amounts to half a percent of revenues (immaterial to the company) can be very significant to the outside world. Of course then the impact, for the company, could arrive in other ways, such as through reputational impact.

As above, with the rider that this should be done with specificity, but not necessarily with quantification. (This is not to deny the value in numbers – where things can be quantified in a meaningful way it really helps.) However, quantification can sometimes be reductive. Something that looks very small as (for instance) a percentage of sales can be a lot more important than it looks. What matters is to understand the importance of key issues in the overall context.

Investors also need to understand the operational context – it is not enough for mining companies to discuss water and energy as potential constraints, for instance. What investors need to know is where such constraints are affecting operations, and how.

⁴⁸ UBS Americas Inc, an affiliate of UBS Limited, owns a minority equity stake in GMI.

⁴⁹ Interviewed on 29 February 2012

The approach to reporting needs to be logical and consistent. Inconsistency is a major headache. For instance, if a given number appears in a different report or report section from year to year, or the unit of reporting changes, this vastly increases the analyst workload and makes meaningful comparison difficult.

The approach to reporting needs to be logical and consistent

It's also important to be realistic about what is possible at this juncture. It's worth remembering that GAAP took a century to resolve. Relevant qualitative information produced on a consistent basis may be the best that can be done at the moment – this is far better than reporting boilerplate numbers that do not mean much.

There is a significant tension between two approaches – the full suite of information versus reporting on what matters to the business, and to the stakeholders in context.

Who benefits from integrated reporting? Who is potentially at a disadvantage?

Some are concerned about the risk of giving away information that is relevant to competitive edge. Others are concerned about potential legal liability.

How do you think integrated reporting might change behaviour or decision-making of companies? Investors? Others?

Speaking in general terms, the people involved in collating ESG data are rarely at the core of the business. With no connection, there can be no behavioural change. Data collection should happen at the point of operations and should also be in front of the Board. If sustainability metrics were linked to executive pay, there would be a direct behavioural connection.

Some of the most exciting developments are happening at companies that are trying to use the existing language of accounting in innovative ways to incorporate ESG. For example, I recently read the annual report of the Brazilian cosmetics firm Natura, which calculates, as a contingent liability, the costs it *may* one day occur as a result of its GHG emissions.

Some firms are using existing accounting language in innovative ways

Who is determining the new standard for reporting? Who is participating? Who is missing from the dialogue?

A wide range of different parties are trying to mandate or standardise when it may not always be appropriate to do so. It's important to sectorize, as GRI does.

Who (what kind of organisation) is opposed to integrated reporting and why? What do you think the response should be, and from whom?

There isn't any single party clearly opposing it. Some are concerned about the risk of giving away information that is relevant to competitive edge. Others are concerned about potential legal liability.

What do you expect might be the timeline for the arrival of integrated reporting?

GAAP took a century to develop!

What practitioners think

In this section we talk to a small number of investment houses. Clarity, connection to the business model, and common sense are common themes in all of these discussions. They are in alphabetical order by firm.

BlackRock

Amra Balic – Head of Corporate Governance and Responsible Investment (CGRI) in EMEA⁵⁰

What do you MOST want to see in an "integrated report" defined as a company report that effectively integrates ESG?

In financial statements, I most value readability and connectivity between key pieces of information and the company strategy.

Speaking as an investor I want better information presented more clearly, but not more information. Taking the remuneration report as an example, it should be easy to see the connections between performance targets, what was achieved and what is paid.

Better information presented more clearly

How do you define an integrated report, and what are the primary differences from conventional reporting?

I find it hard to understand why the main company report and the sustainability report should be separate. But that's my perspective. In practice, many financial analysts and companies don't seem to see the rationale for integrated reporting. But in my view, key risks including those that are SRI-related should be discussed on investor day and in the annual report, and not in a separate document or meeting.

Who benefits from integrated reporting? Who is potentially at a disadvantage?

Investors, companies and analysts would all benefit. I can't think of anyone who wouldn't benefit from improved clarity.

Everyone would benefit from integrated reporting

How do you think integrated reporting might change behaviour or decision making of companies? Investors? Others?

Integrated reporting would have the effect of bringing SRI out of the silo – this would be a valuable change in behaviour. When disclosure starts changing you can see a reaction down the analytical food-chain as different research providers react to it.

Who is determining the new standard for reporting? Who is participating? Who is missing from the dialogue?

A number of parties seem to be influencing the debate, particularly owners of different codes such as the UK's Financial Reporting Council (FRC) and the GRI.

⁵⁰ Interviewed on 8 March 2012

Who (what kind of organisation) is opposed to integrated reporting and why? What do you think the response should be, and from whom?

I can't think of anyone who is in opposition. In general, portfolio managers seem to me to be supportive of it.

What do you expect might be the timeline for the arrival of integrated reporting?

It will take quite a long time before we arrive at fully integrated reporting. The higher-risk sectors such as oil, mining utilities and chemicals may well be the first integrated reporters.

Higher-risk sectors (oil, mining utilities and chemicals) might be the first integrated reporters

Natixis

Herve Guez – Head of ESG Research and Engagement at Natixis Asset Management⁵¹

We view integrated reporting as an excellent initiative. We support it and participate actively in the work of the International Integrated Reporting Council (IIRC)

What is integrated reporting?

An integrated report aims at giving a coherent and overall view of a company strategy, its financial and non-financial objectives, its governance, and its performance. Each of those elements can then be presented in more detail outside of the integrated report.

The annual report was created with a financial logic in mind, while CSR reports reflect a responsibility towards a larger group of stakeholders, but often there is no connection between those two reports.

What are the benefits and drawbacks of integrated reporting?

There are only advantages from an investor standpoint, in our opinion, as it should give a more comprehensive view of the global strategy of a company, its impacts and its performance (both financial and extra-financial).

Some companies might perceive (erroneously) integrated reporting as just another burden on their reporting.

What will integrated reporting change?

An integrated report should allow (along with many other practices) to depart from a purely financial logic, with decisions centred on short-term return on investment, and move towards a longer-term approach. This way, long-term impacts, which are not always possible to quantify, won't be ignored in investment decisions made by companies and investors.

Integrated reporting allows a move away from purely financial and short-term logic, and towards a longer-term approach

Who benefits?

Short term, companies with lower or positive environmental and social impacts should benefit, and conversely, companies with larger negative impacts would be more exposed.

⁵¹ Interview by email, 28 February 2012

Geographically speaking, Europe should be relatively well positioned, while China may be at a disadvantage. Industry-wise, the extractive industries should be at a disadvantage, while solution providers should relatively benefit (renewable energies, recycling, etc).

Large complex and multinational companies should be less well positioned (efficient reporting requires heavier processes and controls for those companies). Smaller companies should benefit (as it is easier to understand and measure impacts).

In the long term, this better assessment of externalities will benefit all, because it is a condition for a sustainable macroeconomic development, and also micro.

Who participates?

This question touches on what is probably the main problem of the IIRC: its governance. The approach is too Anglo-Saxon: it does not include enough policymakers.*

Who is opposed to it?

Habit!

Timeline

A question mark. This will depend on the governance of the process.

*UBS comment:

A review of IIRC membership finds that representatives of the accountancy world make up 29% of the Council, sustainability specialist bodies account for 26%, and the corporate sector 17%. These three segments make up 71% of the membership. After that, we count 7% of governance specialists, 7% of development specialists, and 5% each of market specialists, investors and academe.⁵² The "observers" (the IIRC Board) comprise a mix of accounting and sustainability stakeholders. Professor Mervyn King, the IIRC's Chairman, can be described as encapsulating an impressive range of the IIRC's stakeholder interests – governance, academe, sustainability reporting, and regulation.

Overall, we would say the emphasis has been placed on getting expert knowledge round the table, and in our view this is certainly what matters the most at this juncture. However, it seems reasonable to observe that there is room for objective oversight, in order to make sure that a balance of stakeholder interests is maintained. In particular, while the expertise of accounting bodies cannot help but be extremely valuable in the work of the IIRC, we take the view that there is a need to counterbalance the significant weight of accounting bodies in the mix.⁵³ The question is who might provide such independent supervisory oversight. See also the comments of GRI.

⁵² <http://www.theiirc.org/the-iirc/list-of-iirc-members/>

⁵³ Readers may remember press articles in 2010 on the alleged lack of independence of the Accounting Standards Board (ASB). For example: <http://www.telegraph.co.uk/finance/newsbysector/supportservices/8103346/Accounting-Standards-Board-hires-IFRS-architect-Roger-Marshall-despite-rule-controversy.html>

RCM

Bozena Jankowska – Global Head of Sustainability Research⁵⁴

Bozena kindly shared with us her views on what works and what does not in the context of integrated reporting.

What is most needed?

- Clarity on how 'material' ESG factors are integrated into the company's longer business strategy by top management.
- The impact that ESG issues are having on the direction of the business – both positive and negative.
- How the management of ESG issues benefits the business overall in terms of competitiveness, gaining/losing market share, innovation, etc.
- Which ESG issues are important to the business, its strategy and why.
- An idea of the scale of the impact of ESG issues or factors on the business's overall financial position.
- ESG accounting tied into overall reporting would be useful.
- Consistency of ESG data from year to year, to determine progress being made.
- Inclusion of relevant ESG information within mainstream investor communications.

What is not needed?

- Separate tracks for ESG and mainstream investor communications are not helpful.
- Case studies can be interesting but they only provide a small and sometimes irrelevant snapshot, when what we really want to know is the real impact of the issue (addressed in the case study) on the business.
- Mentioning which sustainability indices companies are included in is mostly meaningless to mainstream investors, and yet this is exactly the information often included in the one or two pages on sustainability of a mainstream presentation.
- Data that does not say anything meaningful in regard to the core strategy and/or is not overtly connected to it is obsolete. For example, reams of data on carbon emissions or amount of paper recycled are not intrinsically useful.

⁵⁴ By email, 4 April 2012

Threadneedle

Iain Richards – Head of Governance and Responsible Investment⁵⁵

Iain said the most important function of a good company report is to give a clear view of the relevant elements of the firm’s strategy and progress. The report should discuss directions, risks and challenges and how the company is dealing with them. The report should present the KPIs most relevant to the firm’s core strategy, and performance should be discussed and contextualised. In his view, an “integrated report”, defined as a report that includes financials and ESG content, needs to give “a flavour of where the ESG issues reported on tie in to the business”.

Don’t just report on ESG issues, indicate where they tie in to the core business

Spelling this out further: reporting on a compliance basis is not useful, whereas versus strategic reporting is. Bean-counting is useless; joined-up reporting is what is required. As examples, Iain mentioned the following as irrelevant:

It’s not about bean-counting or boilerplating...

- A discussion of a firm’s distribution policy is meaningless unless done together with the reinvestment strategy and where this is expected to drive growth and value.
- A listing of types of risks in a generic form, without putting them into the context of the business, its strategy, operations and governance, becomes legal kitchen-sinking.
- In the context of a discussion of a sustainability report, describing ESG procedures and data-gathering without indicating how the risks and opportunities are being handled operationally and factored into the strategy misses a large part of the point.

...but joined-up discussion

In recent years Iain observes that financial statements have become less and less clear with a trend toward “quantity, not quality, of reporting”. However, on a more positive note he has seen examples of companies making a positive “step change” towards clarity and more innovative approaches to their reporting. This appears to have been achieved by stepping back and looking at what really matters within the business and what is happening (no boilerplating in sight).

What really matters in company reports should be clear and accessible

Iain is not the only person interviewed in the context of this report to suggest that ease of access to the business ‘story’ really matters. The gist of that and key issues, developments and themes should be readily accessible to the average reader relatively quickly. It should be stressed that this is not simply a superficial point on the subject of clarity in reporting; it’s an important step in the path to arriving at a common understanding and basis for discussion, as well as trust.

⁵⁵ Interviewed 7 March 2012

What leading companies are doing

Integrated reporting is a work in progress. Companies are experimenting with different approaches, some of which we discuss below. This section is not intended to be comprehensive, but to bring together ideas that should help facilitate debate.

Case study: PUMA’s Environmental P&L

Inspiration for Puma’s Environmental P&L (31 December 2010)⁵⁶, which was two years in the making, came from “The Economics of Ecosystems and Biodiversity (TEEB) study⁵⁷, which draws attention to the global economic benefits of biodiversity and valuing natural capital” (p. 3). However, the idea of an “E P&L” goes beyond “green” considerations. Benefits to the business as identified by PUMA relate to strategy (e.g., the identification of sustainable resource inputs in the all-round sense of the term), risk management (e.g., giving an early view on emerging risks) and transparency (from the perspective of shareholders, employees, customers and suppliers). Moreover, financial impact is a key consideration, for PUMA’s definition of an E P&L is as follows:

“An Environmental Profit & Loss Account is a means of placing a monetary value on the environmental impacts along the entire supply chain of a given business.” (p. 6).

A preparatory scoping analysis and consultation indicated that the main areas of impact for PUMA are: greenhouse gas emissions (GHGs), water use, land use, air pollution and waste. The E P&L therefore focuses on these areas, and captures the full supply chain “from cradle to gate”, organised as follows:

Table 6: PUMA – supply chain structure for E P&L

| Area | Typical activities |
|-------------------------|--|
| PUMA operations | Offices, shops, warehouses, business travel, logistics, IT. |
| Tier 1 suppliers | Manufacturing operations - shoes, apparel, accessories. |
| Tier 2 suppliers | Production of outsoles and insoles; textile embroidery and cutting; adhesive and paint production. |
| Tier 3 suppliers | Leather tanning, petroleum refining, cotton weaving and dyeing. |
| Tier 4 suppliers | Cattle rearing, rubber platforms, cotton farming, petroleum production, other material production. |

Source: PUMA, E P&L, 31 December 2010. See page 10.

Benefits from the perspectives of strategy, risk management and transparency for the firm’s stakeholders

The scope of the 2010 E P&L: Greenhouse gas emissions (GHGs), water use, land use, air pollution and waste

⁵⁶ <http://safe.puma.com/us/en/2011/11/puma-completes-first-environmental-profit-and-loss-account-which-values-impacts-at-e-145-million/>

⁵⁷ <http://www.teebweb.org/>

The Environmental P&L is broken down into the same segments as applied in the firm’s financial statements.⁵⁸ The potential usefulness of this to the financial analyst is immediately apparent from a simple juxtaposition of divisional and regional sales and profit margins for 2010 with the Environmental bottom line. Environmental costs as defined in this report are material (more than 5% of revenues) almost everywhere (Table 7 and Table 8). In terms of risk concentration (“Environmental P&L Breakdown”) the Asia-Pacific region is the most exposed to risk from a geographic perspective, and the Footwear division from a product perspective.

Table 7: Environmental P&L and selected financials by region

| | Environmental P&L, €m | 2010 sales, €m | Gross margin | EPL/ sales | Environmental PL breakdown | Sales breakdown |
|--------------|-----------------------|----------------|--------------|------------|----------------------------|-----------------|
| EMEA | 14 | 1,222 | 51% | 1% | 10% | 45% |
| Americas | 35 | 856 | 47% | 4% | 24% | 32% |
| Asia/Pacific | 96 | 629 | 51% | 15% | 66% | 23% |
| Total | 145 | 2,706 | 50% | 5% | 100% | 100% |

Source: PUMA company reports

Table 8: Environmental P&L and selected financials by division

| | Environmental P&L, €m | 2010 sales, €m | Gross margin | EPL/ sales | Environmental PL breakdown | Sales breakdown |
|-------------|-----------------------|----------------|--------------|------------|----------------------------|-----------------|
| Footwear | 96 | 1,425 | 49% | 7% | 66% | 53% |
| Apparel | 39 | 941 | 51% | 4% | 27% | 35% |
| Accessories | 10 | 340 | 51% | 3% | 7% | 13% |
| Total | 145 | 2,706 | 50% | 5% | 100% | 100% |

Source: PUMA company reports

Of course, the assumptions underlying the above results can be questioned. The input-output model used to drive the numbers for “84% of the impact” (p. 17) derives resource usage for firms on the basis of sub-industry data and, therefore, is known not to be 100% accurate for individual firms – it is an estimate.⁵⁹ However, given the state of play in the realm of data availability, we see this as a reasonable substitute for the ideal, which would be to have the data collected on a bottom-up basis.

Moreover, while this level of detail might be possible for the firm’s own data, it is likely to be a significant challenge in the context of the many small suppliers in the supply chain. The compromise – this model, with granular commentary (e.g., the majority of the supply chain is based in Asia, driven by water use in the “cotton farming and fibre, yarn, thread and fabric mills”) – provides the report user with enough information to know where to focus.

Geographical and segmental breakdown matches annual report

Easy comparison allows user to identify concentration of environmental risk regionally or by product area

Asia/Pacific, where the supply chain is concentrated, is also where concentrated environmental risk is found; from a strategic perspective, this is where to focus, in our view

Footwear: Slightly more risk concentration than for apparel or accessories – suggests scope for innovation in materials

The value of this approach lies in giving the user enough information to know where to look for further information

⁵⁸ http://about.puma.com/wp-content/themes/aboutPUMA_theme/financial-report/pdf/Q4_2010_e.pdf

⁵⁹ The Input-Output model denotes Trucost’s model.

We would also expect the report to evolve, along with improving understanding in the broader context of ecosystems in general. Reports such as the Millennium Ecosystem Assessment and the TEEB have done a great deal to raise the debate, but systems are hard to capture in metrics. As an example, we view field of biodiversity as ill-understood in the public domain (notwithstanding the impressive work of the abovementioned reports), and therefore we would expect the presentation “land use” in an Environmental Report such as this to evolve. (As an example, a biodiversity “VAR” might be a potentially relevant indicator in the area of land use, on the basis that the impact of land use change in one area can sometimes have wider impacts in the system).⁶⁰

In general terms, we would expect the E P&L concept to develop, particularly in complex aspects of the ecosystem not readily captured in single metrics

Table 9: PUMA’s most significant global environmental impacts

| Impact | Measurement |
|---|---|
| Climate change | Tonnes of GHG emissions. |
| Water scarcity | Volume of water used. |
| Loss of biodiversity and ecosystem services | Area of ecosystem converted. |
| Smog and acid rain | Tonnes of particulates, ammonia, sulphur dioxide, nitrogen oxide, volatile organic compounds and carbon monoxide. |
| Leachate and disamenity effects from landfill and incineration of waste | Tonnes of waste to landfill and incineration. |

Source: PUMA, E P&L, 31 December 2010. See p. 16.

As PUMA says:

The world’s biggest and most intractable environmental challenges – such as the on-going degradation of biodiversity and ecosystems – cannot be addressed by one company acting alone[...]. In addition to driving innovation in various areas within our own supply chain and with our consumers, we also need the support of policy makers and the engagement of the whole industry to implement a new model for businesses that works with nature rather than against it and ultimately supports social and economic sustainability. (p. 27).

Once a report such as this has been constructed, we see it as having considerable potential as a strategic tool to leverage in running the business. With the insights it proves that strategic changes to resourcing can be made in such a way as to reduce the impact. As an example, PUMA says in the text to the E P&L: “During 2011 we made a commitment to reduce and eliminate hazardous chemicals in waste water by 2020. In 2012 we will investigate if it is possible to develop a methodology to incorporate this impact into the E P&L”. It furthermore observes that work is underway in respect of the selection of materials and suppliers.

⁶⁰ PUMA identified the greatest land-use in the supply chain as the conversion of land for the farming of cotton, rubber and cattle ranching (Tier 4) – here a detailed analysis was conducted. For PUMA’s own production and Tiers 1-3, a share-of-industry-by-region approach was taken.

Asked what he thought of the PUMA report, IIRC's Paul Druckman (CEO) commented that E P&L work around monetising externalities "provides a potentially immensely powerful tool for integrated reporting". The main challenge, for Paul, is the potential premise made by some that everything can be monetized. Not having a value is not the same as not mattering, nor is it the case that valuation cannot be affected by something that happens to be unquantifiable. Moreover, considering the views discussed in the section on the IIRC, we note that under the IIRC definition of integrated reporting it would not be necessary to put a value on everything – commentary (and perhaps website links) at the core of a fully-fledged integrated report would make it clear where the E P&L connects to the firm's strategy and outlook.⁶¹ Taking all the foregoing into account, Paul believes that the PUMA work is an essential part of the integrated reporting landscape and applauds its development, focus and ingenuity.

Evolution of E P&L represents essential work in the context of developments in integrated reporting

We note that GMI (GovernanceMetricsInternational) assigns PUMA a well above average rating for Corporate Behaviour, and a well below average rating for Market for Control. In the context of the debate currently underway on the subject of capital markets and their social function, it may be worth asking whether it is a coincidence that the first E P&L comes from a company which is not fully open to the short-term forces of capital markets (PUMA has a free float of 19.8%, the main shareholder being the PPR Group (80.2%) within a structure of block-holdings).

The first foray into the publication of an E P&L comes from a company not fully subject to the short-run forces of capital markets

UBS Analyst Fred Speirs, who covers PUMA, comments: "The E P&L is indeed a very interesting initiative by PUMA. In this vein, we have also seen recent innovations on the product side such as the "clever little bag" which has reduced the amount of footwear packaging, and is a good example of environmental sustainability and profitability being aligned. In the wider sportswear field, we would also add that concerns over the social responsibility of sourcing (i.e. child labour concerns) still probably outweigh environmental concerns at this stage for investors, but would agree that the environmental P&L angle is likely to grow fast in terms of importance over the next few years."

⁶¹ Puma's strategic goal as described in the annual report of 2011 is "to become the world's most desirable and sustainable sports lifestyle company" and implementation includes branding and a reduction of the firm's environmental footprint "in terms of energy, water, waste and paper by 25% by 2015". http://about.puma.com/wp-content/themes/aboutPUMA_theme/financial-report/pdf/2011/IAS_Konzernabschluss2011_e.pdf

Company interviews

Chemicals interview: AkzoNobel

This section summarises our interview with Elizabeth Strokes, Sustainability Director at AkzoNobel, and Ivar Smits, Manager of Investor Relations.⁶²

What is integrated reporting?

Integrated reporting is probably best described as an ongoing journey. AkzoNobel started including both financial and non-financial information in its report three years ago. Since then, the report is becoming more integrated every year. This means that discussions on business opportunities and risks increasingly include a sustainability angle and vice-versa.

AkzoNobel started including both financial and non-financial information in its report three years ago

Why has AkzoNobel moved to integrated reporting?

Realising that sustainability is core to the business and that only one strategy underpinned both annual and CSR reviews led (almost) naturally to one report.

What an integrated report is exactly or what this will mean in several years is an open question. However, describing the company's strategy and how sustainability fits in will likely be a central element of integrated reporting going forward. In this respect, the UK annual review (which insists on the role of presenting the business and its strategy) may serve as an important reference. The effort to present how sustainability and AkzoNobel's strategy connect is already reflected in AkzoNobel strategy statement: Value and Values (please see the latest annual report).

Are we moving towards integrated reporting standards?

The main obstacle in the move towards a new standard may come from local reporting regulations. It is easy to add information to annual reports. But the reverse is not true, simply because regulations precisely define what should go in an annual report. Reducing the information in the annual report, and making it more focused and relevant for investors would, therefore, have to be implemented through local regulations.

Local reporting regulations may be the main obstacle in the move towards a new integrated reporting standard

Who opposes integrated reporting?

Compared to financial reporting, integrated reporting leaves more room for interpretation and choice, which in a way makes it a more complex exercise than financial reporting and could slow down adoption. Of course, inertia and the status quo can also be other forces playing against integrated reporting.

Will integrated reporting help sustainability to become mainstream?

Connecting sustainability to a company's overall strategy and focusing on what is material will definitely be a step in the right direction. However, (and taking the risk of over-simplifying) numbers are what is needed because it is numbers that analysts use. That is why AkzoNobel is looking at what is being done in this area, an interesting example being PUMA's Environmental P&L.

⁶² Interviewed on 9 May 2012

What should investors watch?

South Africa is the first country that moved toward integrated reporting standards and, as such, it will be interesting to watch closely during the next season of annual reports. Also worth following are the upcoming new GRI guidelines, which will take into consideration, in some form, the integrated reporting project.

Chemicals interview: BASF

Dr Stefanie Wettberg – Vice President Corporate Communications, BASF SE⁶³

How does BASF define an integrated report, and what are the primary differences from conventional reporting?

BASF has been publishing an integrated report that combines our financial and sustainability reporting in one publication since 2007. We document our economic, environmental and social performance and provide specific examples to demonstrate how sustainability contributes to the success of our company. Integrated reports are aimed at readers from both the financial and sustainability communities. They can serve as a basis for assessing a company's future potential.

BASF has been publishing an integrated report since 2007

What does BASF see as the main pros and cons of an integrated report?

Integrated reports are an excellent way of showing that sustainability is an integral part of our strategy and operations. In addition, we are thus better able to meet the expectations of our target groups. Integrated reporting increases overall transparency and simplifies BASF's external reporting: all information is provided in a single publication that is externally audited. A special challenge we face in the context of integrated reporting is the inclusion of high-quality non-financial data within an ambitious time schedule.

Integrated reporting increases overall transparency and simplifies BASF's external reporting

How does BASF see its integrated reporting evolve in the coming years?

Our report already provides reliable environmental metrics. In addition, we regularly present a comprehensive carbon footprint and conduct eco-efficiency analyses to provide our stakeholders with a holistic perspective on the environmental and economic performance of our operations and products. We publish examples in our report and on our website. Beyond that we are constantly looking at ways to improve our report and cover all material topics relevant to our company and our stakeholders.

How do you think integrated reporting might change behaviour or decision making of companies? Investors? Others?

Our integrated report enables investors and analysts to get a full picture of our company's performance and better judge whether BASF shares or bonds are a suitable investment. Integrated reports are also interesting for a growing number of other stakeholders as they provide a more comprehensive picture of a company. Furthermore, integrated reporting helps us to further strengthen our

⁶³ Interviewed on 9 March 2012

reputation as a reliable and responsible business partner. In the long run, we ensure our licence to operate by providing neighbours, NGOs, politicians and others with transparent information.

Who in your opinion benefits from integrated reporting? Who is potentially at a disadvantage?

We see benefits for all our stakeholders because the integrated report provides them with a holistic view of our performance. To support specific interests of certain stakeholder groups, we publish additional information on our website and in other publications, like our new corporate magazine *Creating Chemistry*. We do not see any disadvantages for a specific stakeholder group, although the people working to produce the report may face additional efforts to produce a high-quality publication in good time.

Who is determining the new standard for reporting? Who is participating? Who is missing from the dialogue?

Activities in the context of the Global Reporting Initiative (GRI) G4 (fourth generation of Sustainability Reporting Guidelines) framework and the International Integrated Reporting Committee (IIRC) will lead to an increasing awareness for integrated reporting. The GRI is currently the most important multi-stakeholder forum to determine new standards for sustainability reporting. Our sustainability reporting is aligned with the international guidelines G3.1 of the GRI as well as with the principles of the UN Global Compact and the Blueprint for Corporate Sustainability Leadership. However, every company should have the freedom to decide whether to publish an integrated or a non-integrated report. The prerequisite for any obligatory standard would be that the authorities setting the legal frameworks at the national and international levels are involved. In addition, an integrated standard-setter comparable to the International Accounting Standards Board (IASB) should be established.

What do you expect might be the timeline for the arrival of standards for integrated reporting?

As mentioned, one can already see an increasing awareness for integrated reporting. GRI is currently working on G4 as part of its multi-stakeholder consultation process and has indicated that G4 will also incorporate the topic of integrated reporting. From what we understand so far, G4 will be issued in the first half of 2013.

Pharmaceuticals interview: Novo Nordisk

How does Novo Nordisk approach integrated reporting?

At a recent UBS Sustainable Corporate Access Roadshow, Novo Nordisk's Executive Vice President and Chief of Staff Lise Kingo, and Vice President of Corporate Sustainability Susanne Stormer, explained to investors that ESG runs deep in the culture of the company, as evidenced in part by its upcoming 20th anniversary of engagement in triple-bottom-line management. Further, the company updated its Articles of Association in 2004 to explicitly say that it does business in a financially, environmentally, and socially responsible manner. The "Novo Nordisk Way", which describes the company's vision and values, including a set of 10 principles ('essentials') for the company – apparently taken quite seriously by employees – includes the triple-bottom-line management

concept at #3 on the list. As such, Stormer, in an interview with UBS⁶⁴, expressed the view that this commitment made separate reporting of financials and sustainability metrics inconsistent with what the company was trying to achieve: “We wanted to evaluate the company based on data that cannot be seen merely from the balance sheet.”

By way of definition, Stormer explains that, “An integrated report is one in which the management discussion narrative covers both financial and environmental and social performance of the company. The other part of the book is the statements: financial statements according to all the standards you can think of (because of company presence in so many jurisdictions) plus social statements and environmental statements, which consist of both balance sheets and notes.

“Our reports are audited by PwC on the financial information. The environmental and social portion is assured according to AA1000 stakeholder engagement principles etc., but we would really like the same level of rigour of data control and capture for all data. Some say that is mission impossible. Currently, yes, because there are no auditing standards.”

How does Novo Nordisk decide what is included?

First, materiality. “It is extremely important to be sure that the indicators to be used are actually material, rather than just what we are able to measure. There are many different denominators; it is unlikely everything can be expressed in monetary terms.”

Secondly, recognising when it is possible to be consistent, and when it is not, really matters. “Where non-financial metrics are used these are proxies for performance and cannot always be meaningfully aggregated. However, we do find that environmental accounting is a bit more mature than social accounting. Whereas greenhouse gas emissions can be treated as a common currency, the social side of the business is not amenable to single indicators, and moreover involves sensitive information.” As an example, Novo takes the view that it is disrespectful to call people ‘human capital’: “maybe we can refer to their productivity, but not treat them like money or assets.”

Financial reports can communicate both by design, and by accident. “The motivation behind reporting is part practical and part messaging. Having two reports runs the risk of speaking ‘two tongues’.”

How can integrated reporting change behaviour?

Stormer refers to an example of how the non-financial information provided by an integrated report could be important to investors. In a Harvard Business School case by Eccles, an investor includes emissions and carbon intensity in his analysis as a proxy for productivity relative to competitors. As quoted in the case study, this particular investor’s reasoning was that: “I track that data because it gives me a window into the efficiency of their production... Novo Nordisk’s ability to do more while using less waste, less water, less CO₂ provide

Tension between integration and complexity – multiple standards in conventional reports and sustainability reporting alike for global firms

Novo Nordisk aims to go beyond what can be measured easily, and beyond what can be put into monetary terms...

...as well as recognising what cannot be done – there is no one-size-fits-all

Care needs to be taken with unintended messaging

ESG data as confirmation of business model success

⁶⁴ Interviewed 8 February 2012

an indirect view of how good they are at lowering their production costs.”⁶⁵ This demonstrates that the data can provide a signal reflecting the company’s strategy.

In order to provide investors with more signals of materiality and more information upon which to make decisions, companies have to go beyond official reporting: “Reporting is an important vehicle for communication, but it is not everything,” according to Stormer. It would be a case of the tail wagging the dog to expect reporting to fix everything.

In this vein, Novo has been using a methodology similar to the Porter ‘creating shared value’ approach to perform case studies, which it calls ‘Blueprints for Change’ and can be found online⁶⁶. “We explain how we do business in different markets and use ESG to create business value. We need to speak with numbers. This provides a format that is not the annual report. It still is data driven, but doesn’t have to be company-wide or global. We can indicate that Novo is creating value for the business through other metrics such as market share, position, employee engagement, reputation AND benefits for society.” One of these blueprints provides a study on the case for a carbon reduction strategy: “It provided a very attractive return on investment! This is something that decision makers – both investors and operations – can understand.”

Final thoughts from Novo Nordisk

Stormer summarizes her view: “I feel strongly that sustainability reporting needs to be better regulated. It may seem strange for a business to want this, but this field should be on equal footing with financial reporting. It’s equally important and making it a requirement would make it clear that it sits on an equal footing.”

Her discussions with colleagues at other companies also illuminate that: “Integration, however, could raise some practical issues. Some firms are not comfortable putting the sustainability report under legal scrutiny. There are things that a company may not be able to say in an integrated report that could be said in the sustainability report.”

Technology interview: Intel

Suzanne Fallender, Director of CSR Strategy and Communications, Intel⁶⁷

How has Intel been looking at the concept of integrated reporting?

The concept and vision of integrated reporting is aligned with the steps we have taken in recent years to outline the connection between our approach to corporate responsibility and the creation of business and social value. We have included corporate responsibility information in our Annual Report and Form 10-K, our Proxy Statement, and our Annual Stockholders’ Meeting presentations. Our annual Corporate Responsibility Report draws directly from 10-K language to describe our business, our vision and strategy, and financial results. A few years ago, we also began using the same cover design to connect the documents.

Reporting is simply a communication mechanism – don’t expect it to fix everything

Sustainability reporting – regulating it would give it a firmer footing

Integration could mean less freedom to communicate between the lines

⁶⁵ Harvard Business School, *Novo Nordisk: A commitment to sustainability* by Robert G. Eccles and Michael P. Krzus, Rev: 9 January 2012

⁶⁶ <http://www.novonordisk.com/sustainability/how-we-manage/blueprints.asp>

⁶⁷ Interviewed on 9 April and 18 May 2012

What is Intel doing differently this year?

Many of the examples of integrated reports are from companies that were still producing a full annual report when they decided to shift to an integrated report. For many years, we have not had a standalone annual report – instead our annual report is a six-page “10-K wrap.” So, one question we have asked ourselves is: “How we could best operationalize the integrated reporting concept without having to create an additional new separate report?”

So, this year, in addition to continuing to integrate information into the 10-K wrap and the 10-K itself, we decided to try something new for our Corporate Responsibility Report. We have taken key elements recommended by the International Integrated Reporting Committee and included them in a new section of this year’s report entitled “Our Business and Integrated Value Approach.” This section includes: information about Intel and our operating context, risks and opportunities, strategic objectives, governance and remuneration systems, performance and goals, and future outlook.

This new integrated value approach section can be read as part of our complete GRI-based 2011 Corporate Responsibility Report, or it can be downloaded as a separate document from our Report Builder website. Our hope is that this modular approach could meet both the needs of those readers interested only in an integrated report as well as those stakeholders who are looking for more detailed sustainability information. We are interested in readers’ feedback on this approach, and hope that it serves as a helpful example for other companies as they move along the path toward integrated reporting.

Where do you see both sustainability reporting and integrated reporting headed in the next five years?

We will likely continue to see an increase in the number of sustainability reports at companies worldwide, using the GRI Guidelines. As more companies take steps to understand the impact of their supply chains, more may request their suppliers to be more transparent regarding their sustainability performance. At Intel, we have taken steps over the past few years to integrate corporate responsibility criteria into our supplier expectations, scorecards, and supplier awards criteria. In early 2012, we also formally requested that our top 75 suppliers publish sustainability reports using the GRI Guidelines beginning in 2013.

Likely to be an increase in the number of sustainability reports at companies worldwide, using the GRI Guidelines

With respect to integrated reporting, we expect to see a good deal of experimentation with different formats and ways to advance the concept in the coming years. In addition, we will likely see an increase in tools and approaches to better measure the financial and long-term business and social impact of corporate responsibility initiatives, such as discussion around shared value measurement and work to develop clearer KPIs used by sustainability raters and investors. A few years ago, working with a team from our corporate finance organisation, we developed an integrated value framework and continue to work on development of supporting finance tools to more effectively embed CSR factors into our decision-making.

Also, the issue of report assurance will likely become more important, as companies take steps to validate and improve their sustainability data collection

and reporting processes. Intel actually started down this path with our 2011 Corporate Responsibility Report, engaging Ernst & Young LLP to conduct an independent review of selected indicators contained in our report in accordance with AT 101, Statements on Standards for Attestation Engagements, of the American Institute of Certified Public Accountants (AICPA).

Utilities interview: American Electric Power

Sandy Nessing, Managing Director, Sustainability & ESH Strategy & Design, AEP⁶⁸

Why did AEP begin reporting on ESG performance?

In 2004, the AEP Board of Directors published a report⁶⁹ driven by a shareholder resolution asking for disclosure of how the company was managing risks around environmental regulation. The result was a groundbreaking report, and eventually we realised the need to be more transparent overall in our reporting and to be broader than just environmental performance. The company was facing significant risks as one of the largest emitters in the country, but we were concerned about all of our environmental impacts, and not just carbon emissions. What made these most material was that no one knew what we were doing in these areas.

One example was the company's intensified focus on safety. Historically, there were employee fatalities nearly every year between 1970 and 2005; in fact, only one year – 1997 – were there no employee fatalities. Without realising it, we had adopted a culture that placed a high value on safety yet accepted that injury or death was inevitable because of the industry we operate within. We realised the need for a culture change and during the last five years, by putting safety and health in our sustainability focus, we have made significant progress toward reducing harm to employees as well as changing that mindset. We also realised there were other misperceptions about AEP that we needed to change. One of them was our position on climate change. Many advocates we talked to thought AEP was wholly opposed to any climate solutions, which was not true. It may have been a fair description two decades before, but currently could not be further from the truth.

I had pitched integrated reporting from the beginning, but it did not go over well. In the end, I'm glad that it was struck down, because it was important to first grasp what CSR reporting meant and what the value is to the company. This was an uncomfortable process for the company because it was disclosing things that it had not been otherwise. There were ways to find some of the data on an EPA database or elsewhere, but you had to dig for it.

How did integrated reporting end up being adopted?

In 2009, I asked investor relations, do you bring the CSR report with you to meetings and are investors interested? It turns out that they had stopped bringing the annual report altogether and only brought the sustainability report. The annual report did not address climate change or other environmental risks with

Idea of integrated reporting was controversial within the company to begin with

⁶⁸ Interviewed on 16 May 2012

⁶⁹ AEP, "An Assessment of AEP's Actions to Mitigate the Economic Impacts of Emissions Policies," 31 August 2004. <http://www.aep.com/environmental/reports/shareholderreport/>

the kind of detail they were looking for. Investors wanted to know, how are we managing these risks? This was the crack in the door for us to connect the dots. We had the support of investor relations, and made the business case to the CEO and CFO. And they were on board.

We had looked at what companies had been doing, especially in Europe. Some had reports with hundreds of pages. We did not want that. We wanted everyone to see the connection, whether they were an employee, customer, or shareholder between financial and non-financial performance. The goal and the approach were about connecting, but we did not have a framework. This was before IIRC, and before GRI started bridging to that with G4. We worked with the planning and budgeting, policy, regulatory affairs, IR and (especially) risk management teams. In this way, material risks to the company were being connected through sustainability metrics.

This year, we went even further and aligned the process with the 10-K. We have been migrating data from the CSR report to the 10-K, especially after the SEC guidance on climate change. We now work side by side to see what can be pulled into each report. It is very important to us to get in front of the financial community by putting it into the 10-K. It was yet another step toward full integration of financial with non-financial performance. A couple of years earlier, our sustainability metrics were integrated with the company's strategic plan. This means to me that it's working. We are breaking down silos and it all is coming together.

[Company now migrating CSR data to its 10-K filing](#)

[Does the lack of US climate change policy make this less compelling?](#)

Climate change was an early driver, but so many other things have come up that are just as, or even more, critical. Maybe people do not believe climate change policy will happen, but no one is saying that this level of transparency isn't valuable. Energy security is another rising issue. Especially low natural gas prices and a regulatory environment forcing a shift away from coal, environmental concerns of every new technology (e.g., fracking) are cropping up. There are also reliability concerns, particularly with the old infrastructure we still have. We really need to modernise the electric system in this country. These are all longer-term concerns we need to be watchful of.

Sell-side analyst perspective – connecting ESG to the financials

A view from UBS Global Equity Research

In believing that financial statements and reports should be designed to give a “true and fair view”⁷⁰ of the firm, we are borrowing from the UK Companies Act of 1947 and onwards, as well as the Fourth Directive of the European Council. A “true and fair view” of the firm (framed as “fair presentation” under International Accounting Standards)⁷¹ will, by definition, include information that is (or is likely to be) material to the business, and should do so in a transparent manner, where necessary facilitating peer-group comparison. Just as a well-framed set of financial statements should present a “true and fair view”, a complete investment analysis requires that all relevant information be taken into account. In a nutshell, we believe environmental, social or governance issues that are relevant to the core business of any given firm should be integral to company reports and integral to the investment decision-making chain.

Before proceeding to consider the issue of extra-financials at the core of the debate over integrated reporting, we think a pause is in order to recall that it took many years to arrive at conventional accounting frameworks, and, although they have been around for a very long time, transparency issues still arise. Adjustments can be material, and can be positive or negative, as shown in the box below.

- Operating and finance lease accounting, only very recently harmonised by the IASB and the FASB, was negative for airlines, retailers and leisure.
- Regional granularity for some firms in the pharma sector translated to a boost in model values in a UBS report.

Sustainability, environmental, social or governance issues relevant to a firm’s core business should be integral to company reports

⁷⁰ <http://www.hmrc.gov.uk/manuals/bimmanual/bim31005.htm>

⁷¹ According to the Financial Reporting Council, which obtained a legal opinion on this matter in 2008. <http://www.frc.org.uk/images/uploaded/documents/Paper%20True%20and%20Fair.pdf>

Case-study 1 from so-called mainstream investing

As described in UBS notes of 13 September⁷² and 14 October 2010⁷³ the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) started a joint project in 2006 to harmonise the treatment of financial and operating leases. The new standard, terminating the distinction, is likely to be applied from 1 January 2013. Expected impacts:

- Airlines, retailers and leisure companies the most affected.
- Impacts “more pronounced than expected” as companies will “capitalise lease payments over the expected rather than the contractual lease term. In addition, companies will not only capitalise fixed lease payments, but also variable leases that, for example, depend on revenues.” (Jullens, 14 October 2011).
- The change affects the income statement through a change in the amortisation charge, and the interest cost, with the impact on net profit likely to be negative.

Case-study 2 from so-called mainstream investing

We go back to September 2010 for a very good example of a distortion in disclosure that we see as impeding market efficiency. The pharmaceuticals team wrote: “With emerging markets now large enough to matter (c25-30% of sales for leaders in pharma), lack of EM disclosure on a product-level basis means analysts cannot accurately model a key business driver that has shown >15% growth YTD. After AstraZeneca became the first pharma company to provide product-level enhanced geographical disclosure with Q1 10 results, it has seen >US\$3bn (>10%) in 2014 sales upgrades. We believe bigger upgrades are possible elsewhere in the sector.”⁷⁴

An overall goal – better reporting

The important point communicated by these (“mainstream”) case-studies in combination is that the stakeholders currently debating integrated reporting are addressing an issue of general relevance to the compilers, users and auditors of financial statements.

Unsurprisingly, key stakeholders in the debate (such as investors) have not yet reached consensus on what should be included in the context of integrated reporting. GMI’s Kimberly Gladman observed that there appears to be a “tension” between two philosophies: the need to present a full suite of information versus the need to have only the information that “matters”.

[The UBS ESG Analyser framework](#)

⁷² *European Small and Midcaps, Impact of capitalising operating leases*, Marcus Baeumer, Alex Hugh, Dennis Jullens, Bosco Ojeda, 13 September 2010.

⁷³ *Valuation and Accounting briefing*, Dennis Jullens, 14 October 2010.

⁷⁴ *Q-Series®: UBS World Pharma Model. Global Pharma: Doing well by doing good?* Gbola Amusa and team, 21 September 2010.

At UBS we have tended to focus on “what matters”, and this approach is reflected in the June 2011 ESG Analyser, where we take a sectoral approach and seek to tease out what matters in the competitive landscape. We define the world in terms of Porter’s well-known five forces: intensity of competition, bargaining power of suppliers, bargaining power of buyers, threat of substitute products and threat of new entrants. In this context, we think about the small number of core competencies that we see as really key to firms in the industry, selecting from the following: key external dependencies (such as access to raw materials), customers, product, supply chain, human capital and reputation.

Table 10: Core drivers relevant to most businesses

| Core inputs | Financial materiality indicators | Environmental and social metrics or narrative |
|-----------------------|---|---|
| External dependencies | Leverage, interest burden. COGS % of sales. Energy costs % of COGS. Company size: absolute revenues, numbers employed geographic sales segmentation. Market capitalisation % of local stock market and (for large firms) GDP. | Environmental footprint – emissions to air, water, land. Energy efficiency. Recycling: waste disposal & management. Social issues likely to affect the operating environment, relative levels of country risk, or the culture of the firm - equality; development indicators (e.g. access to education, gender equality, political freedoms). Governance issues likely to increase risk - e.g., the strength of key institutions such as capital markets, or the rule of law. |
| Customers | Sales growth. Sales segmentation. SGA % of sales. Market share. Number of customers, revenue per customer. | Product labelling. Customer satisfaction. Customer access to necessities (e.g., digital divide, access to medicines, etc.). Customer choice/empowerment. |
| Product | EBIT margin. R&D % of sales. SGA % of sales. Largest product category % of sales. | Product safety. Product quality. Product lifecycle impacts (incl. impacts from usage). |
| Supply chain | COGS % of sales. Overseas procurement – % of total or if possible geographic breakdown. Number of suppliers. | Supply chain % of audited. Sustainable procurement. |
| Human capital | Revenue per employee. Wages % of sales. R&D % of sales. SGA % of sales. Wage quintiles and highest minus lowest (or similar). Brand % of SOTP. Trends in sales growth, margins. | Health & safety, e.g., accidents, lost injury time, sickness absence. Workforce demographics/diversity. Education – secondary, tertiary, % of workforce. Restructuring. Unionisation if relevant. |
| Reputation | Brand % of SOTP. Company size. Numbers employed. | Corporate governance. Risk management in respect of all of the above where relevant. |

Source: UBS

This framework stands at the starting point of our simple question-list:

- What drives the industry?
- What are the business-as-usual (BAU) financial metrics?
- Which environmental, social or governance issues could change the model or the metrics?
- What are the most significant BAU opportunities or threats for the business?
- Which E, S or G trends could change the scale or speed of the BAU opportunities and threats?

Once the relevant (and material, or potentially material) issues identified by question 3 and 5 in aggregate have been identified, their likely financial impact (on, for instance, revenues, margins, or the cost of capital) follows.

Once relevant issues have been identified, the analysis becomes routine

In the following section we look at a few companies in the chemicals, mining, beverages, consumer staples, technology and utilities sectors. We combine a number of views here. In some cases, the Sustainability team puts on the hat of the analyst taking an overall look at the firm – we look to apply the idea of “One Report” shown in Figure 1, starting from the Strategy and seeing where that takes us. Along the way we asked analysts what they thought. For financial analysts, one critical step that is generally missing from sustainability reviews is a convincing argument linking ESG to the financials, which Professor Eccles refers to as ‘connectivity’. What did *not* come up as lacking is increasing information on classic ESG metrics (water consumption, diversity, injury losses, and so on). We stress that the following sections are by no means a complete analysis of individual companies. The idea is to start from the strategy (see Figure 3, IIRC interview) as a naïve user (generalist, rather than stock-covering analyst) and see where the company reports take us.

Chemicals

There are many ways in which companies can “connect the dots” between ESG and the financials. Working with the specialist analysts, we looked for examples of best reporting practices in the chemical sector, where we view issues around resource scarcity and innovation in materials as likely to have a profound impact on the industry in the medium term.

Summarising: Chemicals companies handle environmentally-sensitive materials and also hold the key to resolving many environmental and social challenges, such as providing products that support the procurement of sustainable food supplies for rising population numbers. This suggests that the best chemicals company business models will work with a full awareness of all relevant stakeholders, and this should be reflected in the content and structure of company reports.

Table 11: Strategic issues for the chemicals sector

| Question | ESG issues – chemicals |
|--|--|
| Core drivers | <u>Commodity</u> : Pricing power, capacity utilisation, prices vs raw materials, position on the cost curve. <u>Specialty</u> : Product differentiation and innovation, human capital, value added for customers. |
| Key metrics | <u>Commodity</u> : Earnings momentum, profit margin, cash flow returns, financial and operating leverage. <u>Specialty</u> : Sales growth, earnings momentum, profit margin, cash flow returns, financial and operating leverage. |
| Environmental and social issues that could affect model or metrics | <u>Commodity</u> : Willingness of some countries to be self-sufficient for certain commodity products, availability of cheap feedstock, carbon taxation/costs, site remediation <u>Specialty</u> : Global increase in wealth, scarcity of resources; carbon taxation/costs and other environmental regulation. |
| Governance issues | <u>Commodity</u> : Slowdown of restructuring, state ownership of resources in low-cost hydrocarbon regions (Middle East, potentially Russia). <u>Specialty</u> : Slowdown of restructuring. |

Source: Adapted from the UBS *European ESG Analyser*, June 2011.

BASF, described below, stands out as an example of good practice, in our view. Following the IIRC’s definition of “one report,” we start from the company strategy.

BASF

Neutral, PT €64. UBS analysts: Thomas Gilbert, Joe Dewhurst

Population growth and resource constraints are identified in the opening lines of the BASF *strategy and values* statement as sources of both major challenges and opportunities for the chemical industry, taking a mid- (2020) to long-term (2050) view. This sets the tone for the annual report of BASF, an early adopter of integrated reporting (since 2007) and one of the largest chemical companies globally.

Because BASF is a diversified company (active in chemicals, plastics, oil and gas, agricultural solutions, etc.), sustainability has a very different meaning for the different parts of the business. Therefore, in addition to consolidated sections dedicated to employees and the environment, sustainability is discussed in each reporting segment. In fact, a major difficulty for a diversified company such as BASF is to deliver a simple message on how sustainability relates to its business across the board.

The overall connection between sustainability and the strategy is made evident in BASF's stated strategy, which is fourfold: (1) earn a premium on cost of capital; (2) form the best team; (3) help customers to succeed; and (4) ensure sustainable development.

Looking at our chemical team SWOT analysis of BASF (please see Thomas Gilbert, *European chemicals stocks guide*, November 2011), we see how the company's sustainability strategy plays into its strengths:

- BASF's culture is one of strong technological, engineering and operational excellence, and a constant ambition to optimise processes. An example of this is BASF Verbund production, where by-products of one plant can be used as the starting materials for another, saving resources, energy and minimizing emission.
- High retention of key management over the years and strong talent development.
- Capital allocation is based on very long-term views.

Population growth, resource constraints: challenges and opportunities for the industry

Sustainability has a very different meaning for the different parts of BASF's business

Table 12: BASF SWOT analysis

| Strengths | Weaknesses |
|--|---|
| <ul style="list-style-type: none"> ■ Low-cost production through vertical product integration. ■ Capital allocation is based on very long-term views. ■ Good geographical spread. Local production around the planet, truly matching assets and sales across geographies. ■ BASF's culture is one of strong technological, engineering and operational excellence, and a constant ambition to optimise processes. ■ High retention of key management over the years and strong talent development. ■ Clever approach to expansion in 'high-risk geographies', consistently uses JV or asset swap methodologies to expand the production base. ■ Strong balance sheet and unparalleled cash generation with sector-beating track record on dividends and buybacks. ■ Very tough for any (smaller) company to compete with BASF in any higher-tonnage chemical product line. | <ul style="list-style-type: none"> ■ Still geared towards the fortune of the economy, despite efforts to reduce cyclicality. ■ Complexity of the businesses and broad portfolio make it hard to manage, oversee and analyse ('conglomerate discount'). ■ Earnings perform badly in a deflationary environment as pricing power is a key determinant of earnings. ■ While vertical integration is an advantage once a business is up and running, shutting down integrated chemicals complexes is much more difficult in bad times as it can take one or two months to start up again, whereas isolated plants can be switched on and off within a week. ■ Share losses in more niche-type, service-intensive businesses. ■ Agrochemical business still sub-scale, too dependent on fungicides (ie, weather fluctuations, impact of droughts, etc). Volatile margins versus peers. |
| Opportunities | Threats |
| <ul style="list-style-type: none"> ■ Lower break-even point of chemical operations through each cycle. ■ Able to grow with little need for additional overheads or production base following a spate of expansions between 1993 and 2005. High project returns on debottlenecking exercises. ■ Buying assets or consolidating in a distressed economic environment. ■ Large storage facilities erected in its gas trading business; could make use of spot market opportunities. ■ Monetise hidden R&D assets (along the lines of the 2007 Monsanto collaboration agreement). ■ Given scope to reduce capital intensity: raise cash return to shareholders. | <ul style="list-style-type: none"> ■ Overpaying for acquisitions following the experience with a disciplined but hostile bid for Engelhard in 2006. ■ Declining reserve life in oil production. ■ Political and regulatory risk in emerging markets: BASF is exposed to Russia, China and Argentina. ■ Regulatory risk also exists in Germany (its 'utility' business) from German network regulator, with discussions ongoing about price caps from 2010. ■ Genericisation of the crop protection portfolio and rising R&D and compliance costs a threat to returns. ■ Energy debate and electricity cost competitiveness in Germany. ■ Looming oversupply for key chemical commodities in 2014/15E. |

Source: UBS: Thomas Gilbert, European chemicals stocks guide, November 2011

In this section, we discuss two examples of how ESG opportunities can be framed and reported on:

■ **Reporting convincingly on mega-trends:** Lanxess

Exposure to sustainability mega-trends is a recurring feature of sustainability reports (resource scarcity, mobility, water, etc.), but we find that connecting the top-down story with a micro one can be difficult to achieve. Lanxess provides examples of best practice of reporting on those mega-trends in our view.

- **Sustainable innovation:** Solvay could benefit from increased disclosure in the R&D pipeline

Linking mega-trends to business opportunities is a challenge

Many business opportunities should arise from innovation and new materials in the chemical space, in our view. In particular, we see value in Solvay’s cutting-edge portfolio and its potential for innovation. We believe there is room for investors to further recognize the value in Solvay’s innovation potential, and the company would gain by increased transparency on its R&D pipeline.

R&D disclosure in pharma could be a reference for reporting on sustainable innovation

Lanxess: Framing opportunities arising from mega-trends

Neutral, PT €66. UBS analyst: Joe Dewhurst

In our view, Lanxess reporting is a good example of the opportunities arising from green mobility and how it could favourably impact their business.

Lanxess reporting is a good example of the opportunities arising from green mobility

What stands out in Lanxess’ reporting on green mobility?

- The company provides a global overview of supportive regulation (tyre efficiency labelling) – see table below
- The company has a strong position in the performance butadiene rubber market and gives an indication of capital expenditure in this area
- Critically, green tyres are margin enhancing compared with what they replace, in our view

Where are the opportunities?

In its annual report, the company provides a snapshot of global tyre efficiency labelling regulations, which should drive the demand for performance butadiene rubbers, where Lanxess holds 11% market share.

Our analyst notes that Lanxess is seen by tyre producers as a provider of innovation to enable them to move their tyres up the efficiency chain. The EU and other government bodies will expect tyres to become more efficient over time, and we believe tyre companies will look to Lanxess to provide much of this innovation.

Table 13: Global tyre-labelling initiatives

| Region | EU | Japan | South Korea | US | China | Mexico | Brazil |
|-------------------|---------------|--------------|---------------|---------------|-------|---------------------------------|--------|
| Traction/wet grip | November 2012 | Since 2010 | November 2011 | In discussion | | | |
| Fuel efficiency | November 2012 | Since 2010 | November 2011 | In discussion | | Regulatory initiatives expected | |
| Treadlife | | Not expected | Not expected | In discussion | | | |

Source: Lanxess

Impact on our analyst forecasts

As Joe Dewhurst wrote (2011): “The global market for performance butadiene rubbers was estimated to be worth €11bn in 2010 and Lanxess has an 11% global market share. We expect this market to grow by 3-4% in the period 2011-15.” According to Joe Dewhurst (*Lanxess: Over compensating for near-term risks*, 6 September 2011), tyre labelling will likely bolster the substitution of other rubber products in tyres by performance butadiene rubbers, which commands higher margins.

Solvay: Enhanced disclosure of the R&D pipeline could unlock value

Buy, PT €135. UBS analyst: Joe Dewhurst

In our view, one of Solvay’s strength is its exposure to high-growth sustainability trends (including efficient tyres and environmentally-friendly oxidising agents). In a recent note (J. Dewhurst, *Solvay: on the road to transformation*, 6 September 2011), we highlighted that “longer term investors will see value in cutting-edge growth technologies in the Solvay portfolio”.

We believe that greater disclosure on the R&D pipeline could help unlock hidden value in the company, by shedding more light on its long-term potential. Forecasting R&D potential is not easy, but is common practice in the pharma sector where analysts assign probabilities to product going through.

Greater disclosure on the R&D pipeline could help unlock hidden value

In Solvay’s case, the credibility of R&D projects should be helped by the company’s track record of delivering growth in complex and new materials areas. To some extent, our analyst Joe Dewhurst already factors Solvay’s R&D potential into the valuation:

“Solvay’s R&D spend in Specialty Polymers (21% of EBITDA 2012E) is focussed on high growth mega-trend themes. More than 1,300 pipeline projects and a wide range of end-markets will ensure a solid growth dimension, in our view, which should result in double-digit top-line growth of this division.” (Joe Dewhurst, *Solvay: on the road to transformation*, 6 September 2011)

Mining

Ownership of key assets, asset size, duration of concessions, cost, and growth all connect into the key ESG issues identified by the UBS Mining team in our *ESG Analyser*. Strategy, profitability and sustainability thus clearly connect for mining stocks. How clear is this in the reporting of a typical mining company?

Table 14: Strategic issues for the sector

| Question | ESG issues – mining |
|--|---|
| Core drivers | External dependencies (access to mining assets, political conditions on location), reputation, human capital. Currently: willingness of competitors to ignore reputational issues such as human rights. |
| Key metrics | Commodity prices, extraction and production costs, profit margins. Contingent liabilities. |
| Environmental and social Issues that could affect model or metrics | Environmental clean-up costs. Competitors saving costs through 'dirty' operations. Governments tightening regulation – positive for firms with high standards. Lack of key inputs - water, power & labour |
| Governance issues | Increasing political/country risk. |

Source: Adapted from the UBS *European ESG Analyser*, June 2011.

A convenient test case for the “one report” concept, presented itself in an early May group meeting with BHP Billiton, is described below.

BHP Billiton

Buy, PT 2,400.00p. UBS analysts: Myles Allsop, Glyn Lawcock, Ben Davis

Presenting on BHP Billiton’s Sustainability Briefing, Lucas Dow, Head of Group HSEC (sell-side analyst briefing, 1 May 2012) started with the firm’s strategy, as set out in the Charter that also drives the firm’s values: “Our strategy is to own and operate large, long-life, low-cost, expandable, upstream assets diversified by commodity, geography and market.”⁷⁵ From the perspective of a “one report” reporting structure, we would describe this as the doorway into the firm, although the website is not structured in such a way as to permit a direct trajectory (c.f. Figure 3) from strategy to the next level of core business drivers and key performance metrics.

Nevertheless it is clear that the business is structured so that connections are in place. HSEC is governed by a series of seven Group Level Documents (GLDs) covering Fatal Risk Controls, Environment, Health, HSE and Community, Asset Protection, Aviation, and Reporting. These are the operating documents that ensure BHP’s strategy and values are implemented at all levels of the firm from the perspective of sustainability. Compensation metrics are associated with them, again, at all levels.

Connectivity is fundamental to integrated reporting; however, implementation is a work in progress for the majority of firms, and this is the same for BHP Billiton. Although profitability and sustainability do appear to connect through incentive structures running through the firm, we note that financial statements are targeted at “Investors and Media” whereas the Sustainability Report sits in a different place under the “About us” heading. The BHP Billiton Governance Structure (page 32, annual report) refers to GLDs for the Financial Risk, Business Group Risk and Audit and Market Risk Management Disclosure, but not HSEC. The description of operations in the meeting suggested that all the GLDs connect – this would be worth spelling out for the report user.

Homing in on disclosures, BHP Billiton reports on key performance metrics relating to sustainable operations such as health, safety, environment and community. What can usefully be reported on from an ESG integration perspective is still open to debate, thus the widely-used Total Recordable Injury Frequency (TRIF) and Lost Time Injury Frequency (LTIF) are known to be lagging indicators – the meeting briefly discussed the possibility that “Near Misses” (which are monitored and reported on to the Board) might be a more forward-looking risk indicator. This is a work in progress for all concerned.

Prioritising the issues, it was clear in the meeting that fatalities, health and safety, and the environment were at the top of the Sustainability list – an ordering that is also reflected in the 2011 sustainability report as well as in the CEO’s report (annual report). In the meeting it was also commented that the assessment and peer-group comparison of potential M&A targets incorporates ESG issues as well as the usual financials.

“Our strategy is to own and operate large, long-life, low-cost, expandable, upstream assets, diversified by commodity, geography and market”

Performance in relation to sustainability targets drives pay, at all levels of the firm

Connectivity – not always in place between the business and the “sustainability” channels

What it is useful to report is still an open question

In M&A, the ESG rubber hits the financial road

⁷⁵ <http://www.bhpbilliton.com/home/aboutus/ourcompany/Pages/Charter.aspx>

Rio Tinto

Buy, PT A\$105.00. UBS analysts: Glyn Lawcock, Daniel Morgan

Rio Tinto describes the firm’s mission as the delivery of superior returns to shareholders over time. Rio Tinto (Rio) considers itself a world leader in finding, mining and processing the world’s mineral resources. The company takes a long-term and responsible approach to the group’s business, concentrating on the development of first-class orebodies into large, long-life and efficient operations, capable of sustaining competitive advantage through cycles, and operating (and eventually closing) operations safely, responsibly and sustainably. Rio’s products help fulfil important consumer needs and improve living standards.⁷⁶ This strategy statement suggests a level of fusion between the idea of “sustainability” and the way the firm’s core operations are run.

Those going straight into the ‘Investors’ tab on the website will find that this continues. Some firms use this area of the website to report on the financials, but Rio presents the all-round perspective. As an example, the links inside this tab weave together the safety KPIs, strategy and incentives, pointing the way (via a link) to the remuneration report because a portion of compensation is related to the All Injury Frequency Rate, Significant Potential Incidents (SPI) and a proprietary measure, the Semi-Quantitative Risk Assessment (SQRATM). Other dimensions that can be explored via links include Performance Highlights, Sustainable Investments, the Remuneration Report, and Principal Risks.

This brief review of Rio’s company reports suggests that it is fair to describe Rio’s reports as “integrated” in the sense that key interconnections are made for the report user to follow – it is not left to the report user to seek them out. This seemingly superficial point (on the subject of the way technology is used to connect information) helps to convey a “sustainable business” narrative, in keeping with the firm’s strategy statement.

Beverages

In the beverages sector, reputation, access to raw materials and distribution channels (a mix of human capital and logistics) are the critical inputs to the business. These connect readily to financial metrics such as volume growth, margins and price.

Table 15: Strategic issues for the sector

| Question | ESG issues – beverages |
|--|---|
| Core drivers | Key raw materials inputs include agricultural, water, packaging including aluminium, glass, plastic; dealing with retailers who try to push prices lower; brand reputation is important. |
| Key metrics | Organic volume growth, price, mix and margins |
| Environmental and social Issues that could affect model or metrics | Growing emerging market incomes, political stability and economic health; government view of beverage industry as a tax source/view that it is unhealthy. Responsible drinking: there is a risk that small, non-public, alcohol companies market their products irresponsibly, causing regulators to step in penalising the whole industry. |
| Governance issues | Shareholders have impact on M&A decisions versus family-owned companies; management remuneration in line with shareholders. |

Source: Adapted from the UBS *European ESG Analyser*, June 2011.

⁷⁶ http://www.riotinto.com/aboutus/19602_overivew.asp

A “long-term responsible approach”

Materials for the investor go beyond the financials – we see this as good practice

Technology is used to allow the report user to follow important narrative threads, such as the connection of safety performance to pay

In the following, we look at two companies: Diageo, and Pepsi.

Diageo

Buy, PT 1700p. UBS analysts: [Melissa Earlam](#), [Olivier Nicolai](#)

Diageo’s strategy statement in the 2011 annual report (page 23) points out that the company is the leading premium spirits business in the world by volume, net sales and operating profit, and is one of a small number of premium drinks companies that has global spirits, beer and wine operations. The company manages a broad range of brands across several categories, and utilises its brands, its geographical breadth and the expertise of its people to create long-term value for shareholders.⁷⁷ The text continues with a description of key elements of the strategy, including its societal aspects (responsible drinking) and the potential resource challenges. The one-report “doorway” thus incorporates ESG issues we identify as integral to the core business model in the *ESG Analyser*. The company website is structured along several tabs relating to the brand, the business, CSR and investors.

The strategic “doorway” connects readily to the ESG issues we identify as integral to the core business model in the *ESG Analyser*

At first sight this might look as if separate tracks are followed, but entering any of these tracks from the perspective of the strategy it is already clear how they connect. Reading reports within the area of CSR, what comes across is the overall goal of protecting “long-term value” (Transcript, 22 March 2012 presentation). The business benefits of sustainability (business efficiencies, security of supply, competitive advantage) are clear, no matter which stakeholder happens to be reading them. When, in the investor section, the firm comments that the aim is to “consistently create value for shareholders” the framing gives this a wider meaning than the next quarter’s results. Targets and performance are clearly reported, and “CSR” investments undertaken connect clearly to finance where relevant. The impression we gain from this exercise is that “one report” is present in spirit (no pun intended) much of the time. (An exception in our view is the “Introduction to Diageo” presentation).⁷⁸

The business benefits of sustainability (business efficiencies, security of supply, competitive advantage) are clear, no matter which stakeholder happens to be reading them

PepsiCo

Neutral, PT US\$ 66.00. UBS analyst: [Kaamil S Gajrawala](#)

PepsiCo comments separately on business fundamentals and sustainability, but they come together in the “Vision”, which is to improve continually across economic, environmental and social aspects of the business. Pepsi has also brought together the fundamentals with sustainability in a section of the reporting structure called “Purpose”.

Performance “with purpose” connects the business and the remit of sustainability in several places. Thus, different stakeholders approaching from a different angle can arrive at the same place

The “Purpose” agenda is described on the company website as having four Sustainability components – performance, human, environmental and talent.⁷⁹ Performance in all of these dimensions is noted to be possible because of the firm’s strong performance across all business units, brands and markets. In the

⁷⁷

http://www.diageo.com/Lists/Resources/Attachments/1060/Diageo%20Annual%20Report%202011_FINAL_APRIL%202012.pdf

⁷⁸ <http://www.diageo.com/Lists/Resources/Attachments/1238/Introduction%20to%20Final%20March%202012.pdf>

⁷⁹ <http://www.pepsico.com/Purpose/Performance-with-Purpose.html>

annual report (page 4) we find under “delivering performance with purpose” that the company worked proactively with other stakeholders to create a positive business environment while investing in sustainability as a catalyst for growth. For example, Frito-Lay rolled out North America’s largest commercial fleet of all-electric trucks and in Ethiopia chickpea production was improved in partnership with the World Food Programme and the US Agency for International Development while also addressing malnutrition through the development of a nutritious chickpea-based food. One information trail we see as important in the context of agriculture in developing countries (and a source of potential financial and/or reputational risk) is not currently readily discoverable on Pepsi’s website, and this is the issue of land ownership. This may mean it is a non-issue; however, we were unable to verify this – a seemingly small but potentially important gap in the information trail.

More generally, from a “one report” perspective, we note that the “performance with purpose” strand can be readily identified in a number of places, which suggests, in turn, that this track can be followed from more than one direction by different stakeholders.

Consumer staples

In the consumer staples business the most successful firms succeed with their customers. Everything else follows from that. Customers are increasingly sensitive to green credentials in food and personal care alike, and this concern connects readily to core business competencies such as resource access, supply chain management and product. In this sector, above all, environmental and social issues are inseparable from the business.

In consumer staples, environmental and social issues are inseparable from the business

Table 16: Strategic issues for the sector

| Question | ESG issues – consumer staples – food manufacture and personal care |
|--|---|
| Core drivers | <u>Food</u> : consumer preferences; access to sustainable supplies of raw materials. <u>Personal care</u> : Brand strength, geographical split, category exposure, price point exposure, input cost sensitivity, innovation success, A&P spending, cyclical businesses exposure (adhesives, perfumes), exposure to de-stocking and re-stocking, unemployment and GDP. |
| Key metrics | <u>Food</u> : Organic sales growth, margin, free cash flow. <u>Personal Care</u> : Organic growth, operating margins, EV/EBITDA, P/E, FCF yield. |
| Environmental and social issues that could affect model or metrics | <u>Food</u> : Growing importance attached by consumers to: sustainability, carbon footprint, fair-trade, nutrition. <u>Personal care</u> : Social trends: Rise of male spending on cosmetics and toiletries, unemployment rates, threat of rising taxes. Environmental trends: The general need to reduce energy and raw material usage is an opportunity for product development. Increasing demand for natural products. |
| Governance issues | <u>Food</u> : Increased regulatory scrutiny of health claims. <u>Personal Care</u> : Family ownership and possible lack of independence in the boardroom (Beiersdorf, Henkel, L’Oréal – as defined by GMI). |

Source: Adapted from the UBS *European ESG Analyser*, June 2011

Unilever

Neutral, PT 2,200.00p. UBS analyst: Alan Erskine

Unilever’s strategy, as set out in the firm’s presentation, *Introduction to Unilever*, is to create a better future by creating brands and services that are good for customers and good for others. It hopes to inspire people to take small everyday actions that can add up to a big difference and intends to develop new ways of doing business that will allow the company to double in size while reducing its environmental impact.⁸⁰ In our view this strategy effectively merges business fundamentals, execution, environmental and social issues. This runs right through every aspect of the business discussed in the *Introduction* powerpoint.

This introductory powerpoint is not only found in the general company website, but is also one of the first items to appear for investors under “Understanding Unilever”. It also appears in the text summarising the strategy as the opening item in the financial statements. The CEO’s review covers the macro backdrop, company fundamentals and financials and an update on the long-term vision (growing the business whilst reducing environmental impact), with a mention of a well-chosen datapoint: “Two-thirds of the palm oil used in our business was being purchased from certified sources.” This is something customers care about, and it touches on a resource input that is ubiquitous in the food and personal care sectors. Therefore, it could not be more core to company fundamentals.

A random check for the continuation of the narrative thread finds that targets and performance are reported on for Unilever’s raw materials. Why this matters to (financially focused) investors is made clear (half of Unilever’s raw materials come from farms or forests). Unilever’s top ten raw materials are: palm oil; paper and board; soy; sugar; tea; fruit and vegetables; sunflower oil; rapeseed oil; dairy ingredients; and cocoa and “what matters most” is to source palm oil and paper sustainably.⁸¹

If asked for suggestions, we would make some small tweaks to individual reports to reinforce the connectivity established in the all important annual report. Examples: in the account of raw material targets and performance described above, we would scale raw material costs (as a % of sales for instance); and in the short “trading updates” we would contextualise the “steady and sustainable operating margin improvement”⁸² by linking “sustainable” to the discussion of raw materials in the sustainable living section.

Danone

Buy, PT €59.00. UBS analyst: Alan Erskine

Danone’s mission is “bringing health through food to as many people as possible”. This mission connects easily to a stakeholder approach. The 2011 Results Presentation focuses on financials (sales growth, trading operating margin and free cash flow) and markets (by category and region) until slide 22.

Unilever presents a fusion of fundamentals and finance with environmental and social issues

The firm’s strategy (growing without hurting the environment) is the entry point for discussions whether for investors or the general reader

Growing the business while reducing environmental impact

Raw materials – core to the financials

The internet permits connections to be made

A nice simple “integrated” mission statement

⁸⁰ http://www.unilever.com/images/ir_Introduction_to_Unilever_tcm13-234373.pdf

⁸¹ <http://www.unilever.com/sustainable-living/sustainablesourcing/targets/index.aspx>

⁸² http://www.unilever.com/images/ir_q112-results-presentation_tcm13-286514.pdf

At this point, the key stakeholders are identified as consumers, shareholders, employees, the natural environment and the ecosystem (defined here as the socio-economic environment)⁸³, and some information is given on environmental and social performance metrics (hinting at the possibility that more detail is available). While it is good to see the financials and some ESG information in the same document, we would argue for more linkage between these two dimensions of performance.

Even though (1) Danone’s “integrated” mission statement is an ideal entry-point for an integrated approach to reporting, (2) the firm’s R&D efforts in nutrition must inevitably drive the firm’s social and financial performance, and (3) the idea of “creating shared value” is articulated in the 2010 Sustainability Report, in practice we think Danone’s reports are not easy to navigate for the report user looking for granularity (whether as investor or non-investor).

As an example, the report user seeking the connection between incentives and performance has to seek out the remuneration report.⁸⁴ This turns out to give a verbal description of the drivers of variable compensation, without giving a clear idea of how this actually works – in terms of the emphasis given to the different metrics for instance. Elsewhere, while some ESG performance metrics are given (such as the firm’s reduction in carbon emissions), these KPIs could be more overtly connected to the overall performance of the firm. (Why do carbon emissions matter to the business? Where do they connect or potentially connect to the P&L or balance sheet?). While the Dow Jones Sustainability Index is useful up to a point, we believe it would be more useful to Danone’s report users if the most important KPIs from the perspective of the core business could be identified and discussed in terms of targets and performance relative to targets.

We note that Danone has signed up to the IIRC pilot-study.

Healthcare: Pharmaceuticals

UBS analyst Gbola Amusa expects emerging market growth to be an important driver of revenues for the pharmaceutical industry in the medium term. As a consequence, how access to medicine has historically been handled is turning out to be all-important for growth in the present. As emerging markets gain traction in pharmaceutical company business models, we expect that access to medicine and vaccines in developing countries will receive increased attention. The reputation of the industry has sometimes suffered from the view that it was maintaining high prices in countries with low-income populations.

Reports are not easy to navigate for the user trying to follow key threads

What matters most and why it could be more clearly spelt out.

Danone is an IIRC pilot-study participant, suggesting that developments may be under way

⁸³ <http://finance.danone.com/phoenix.zhtml?c=95168&p=irol-results>

⁸⁴ http://finance.danone.com/phoenix.zhtml?c=95168&p=irol-govHighlights_pf

Table 17: Strategic issues for the sector

| Question | ESG issues – pharmaceuticals |
|--|---|
| Core drivers | Patients, insurance coverage, economic & wealth transfer, product pipeline, healthcare providers, government, human capital, financial capital. |
| Key metrics | Sales growth, profit margins, FCF generation, net debt/EBITDA, valuation metrics: PE growth, PE, EV/EBITDA, FCF/EV, dividend yield |
| Environmental and social issues that could affect model or metrics | Global wealth transfer, national insurance coverage, government regulation/intervention, health and safety, environmental regulations (e.g. waste disposal), clinical trial regulation (e.g. use of animal testing), working conditions for staff, healthcare infrastructure/guidelines development, improved access to neglected disease medicines. Further scientific research on new drugs with high unmet need/public health. Government healthcare expenditure. Policies on manufacturing, regulation on distribution, manufacturing, development. Growth of chronic disease prevalence. |
| Governance issues | National insurance coverage, government regulation/intervention. Composition of board, shareholder rights |

Source: Adapted from the UBS *European ESG Analyser*, June 2011

Novo Nordisk

Neutral, PT DKr 875.00. UBS analyst: Andrew Whitney, PhD, CA

Novo Nordisk has used an integrated business approach for many years. The company published its first environmental report in 1994 and its first social responsibility report in 1999. Subsequently, Novo's Articles of Association were amended in 2004 to explicitly state its goal to conduct business "in a financially, environmentally and socially responsible way."⁸⁵ Since that year, Novo has been publishing an integrated financial, environmental, and social report. The inclusion of detailed explanatory notes to accompany the company's non-financial statements even from the early days has been noteworthy.

Novo Nordisk has used an integrated business approach for many years

Novo is primarily focused on patients, and the company's homepage and annual report showcase this with a peppering of personal patient stories. Further, the Novo Nordisk Way Essentials, a set of the top 10 values of the firm, puts as its first priority "a patient centred business approach." The third priority points to accountability for financial, environmental, and social performance.

The annual report⁸⁶ appears primarily as a combination of financial and sustainability reports with ESG metrics and discussion remaining largely segregated. A significant number of indicators representing social and environmental performance are displayed alongside financial ones on the inside front cover Key Figures as well as within the Consolidated Statements, though with little intermingling. Social metrics include the number of healthcare professional trained in diabetes, employee turnover, percentage of employees trained in business ethics, and proportion of diverse senior management teams. Environmental metrics include energy use, water use, and waste generation. In the section highlighting performance for the year, again social and environmental comments follow the conventional financial remarks in series, but generally the interaction of these two is not explicitly stated at this point.

Most of the above separation is reconciled (though unfortunately not quantitatively) in the two-page section titled "Triple bottom line management"

⁸⁵ Historical information from "Novo Nordisk History," Novo Nordisk A/S 2010.

http://www.novonordisk.com/images/about_us/history/history_uk.pdf

⁸⁶ http://webmedia.novonordisk.com/hncom/images/annual_report/2011/Novo-Nordisk-AR-2011-en.pdf

(page 20-21). Triple bottom line (TBL) management is Novo’s way of “translating into practice” what it has preached for all this time. The three goals (financial, social, and environmental) are almost always referenced together in company literature, and here it explains a little of why and how. The section begins by stating that the core goals of the company are to grow its business in ways that are both profitable and responsible, with the intention of helping people live better lives. The interaction of the three bottom lines is articulated in discussions, such as that on expanding access to healthcare (through pricing and strategy) and thus tapping into new markets. Another explains that a healthy and engaging work environment leads to employees who are motivated and retained. A desired “decoupling” of environmental impacts from business growth is mentioned, but for all the articulation of social and governance impacts on business, those explaining the same for Novo’s environmental goals is notably missing. Other than this omission, this part of the Report in our view represents solid integration.

The examples of TBL value creation are further explored in separate case studies under Novo’s “Blueprint for Change” Programme⁸⁷ (referenced, but not included in the annual report). This is an innovative way to communicate Novo’s business value stemming from selected sustainability initiatives and investments. As such, we would expect these to appear on the Investors web portal, but unfortunately they are relegated to a sub-page on the Sustainability portal. We hope that once more Blueprints are made available (currently there are three), they will become a more prominent display of Novo’s successful value integration.

Industrials

In general terms, the product suite of most industrial firms facilitates the leverage of energy by the end user of industrial equipment. In light of long-term trends, energy efficiency, conservation, and the optimal deployment of the global portfolio of energy sources are where the key sources of competitive advantage are to be found. This point is core whether the industry is viewed from the perspective of the investor, or any other stakeholder.

All roads lead to energy

⁸⁷ <http://www.novonordisk.com/sustainability/how-we-manage/blueprints.asp>

Table 18: Strategic Issues for the sector

| Question | ESG issues – industrials |
|--|---|
| Core drivers | Technical expertise/know-how. Global economic activity and confidence. Depending on the precise business mix of firms in the sector, trends in any of commodity prices, construction, infrastructure investment, power generation, T&D, industrial capex, automotive production, construction, infrastructure investment, transport volumes, productivity improvements, emerging market demand/competition. |
| Key metrics | EBIT margins, organic orders and sales growth, ROCE, free cash flow generation |
| Environmental and social issues that could affect model or metrics | Shift of focus to greener portfolio, positioning in emerging markets. Environmental regulation (incl. climate change); the social effect of plant closures due to restructuring measures, globalisation. Potential environmental impact of core activities. |
| Governance issues | In emerging markets, such as government policies of protectionism to champion local players; technology transfer; labour union conflict during layoffs and restructuring process. |

Source: Adapted from the UBS *European ESG Analyser*, June 2011

GE

Buy, PT US\$23.00. UBS analyst: Jason Feldman

Most people, thinking of GE, will remember the arrival of “Eco-magination”. Although clean energy is only one of the many things GE does, this idea is communicated as core to the company strategy. Hence, the entry-point to GE’s corporate website puts “imagination” and “innovation” at the top of the page.

The next tabs on the home page cover the expected – products & services, the company news, investor relations. So far, so conventional – except that innovation in clean technology is the first thing any report user of any of the website report sections will see, having clicked on the tab, along with nuggets of information that convey “who” GE is: “GE power generation equipment and technology is used to generate a quarter of the world’s electricity...”.

The positive about GE’s reporting is the consistency of the message. GE’s Letter to Shareholders, for instance, cites US\$21bn in clean energy revenue, “growing twice as fast as the company average” (p. 2). (This puts Ecomagination at 14% of annual revenue (US\$147.4bn) in 2011, its seventh year of operation).

Given the significant amount of the business that sits outside the purview of Ecomagination, we note that Corporate Governance research specialist GMI assesses the company as high risk from an accounting perspective, and also high risk from environmental and social perspectives. Only part of this is down to the size and complexity of the business. The key point to note in the context of “integrated reporting” is that, while the message on where the company is going is consistent, the reader of GE’s “One Report” of the future might need greater emphasis on the rest of the business at the point of entry.

Why innovation in clean technology matters (strategically speaking) is clear

Consistent message on the strategy

More emphasis needed on the rest of the business up front

From the perspective of the institutional investor using GE's reports, UBS analyst Jason Feldman notes that there are some concerns and issues with GE's disclosure and reporting. For example, considering GE has a large finance business (total assets ~US\$570 billion, ENI (Ending Net Investment) ex-cash of ~US\$435 billion), investors and analysts question why its reporting does not adhere to the same format and level of detail as other large banks and financial institutions. While GE has made substantial progress on improving their disclosure, we believe there is still work to be done (and GE has committed to improving disclosure for Capital Finance over time). GE has also re-classified their segment reporting structure several times, which makes certain types of historical analysis extremely difficult. We believe both of these issues would need to be addressed from the perspective of those focussing on Integrated Reporting as defined by the IIRC.

Institutional investors find disclosure gaps, and need more consistency

Technology

The technology sector has a wide range of social and environmental impacts, often delivering transformational technology from a social perspective, but also delivering solutions that depend on readily available energy with all of the environmental read-throughs that implies.

Table 19: Strategic Issues for the sector

| Question | ESG issues – technology |
|--|--|
| Core drivers | Intellectual property and the related rights, global distribution/local feel; technological strength, competition, mobile data usage. |
| Key metrics | Revenue growth, EBIT margins, FCF margins and asset turn |
| Environmental and social issues that could affect model or metrics | Resource usage, power concerns for semiconductor manufacturing, recycling of equipment, and social exclusion from internet usage. Growing demand for "green IT". The opportunities and threats inherent in Moore's Law – efficiency versus growing energy usage in absolute terms. |
| Governance issues | Pension deficits leading to political risks, political issues relating to dealing with competitors, and legal action over intellectual property, antitrust actions. |

Source: Adapted from the UBS *European ESG Analyser*, June 2011

Intel

Buy, PT US\$34.00. UBS analysts: Uche Orji, Steven Eliscu

The 2011 annual report⁸⁸ sets out the firm's strategy early on. This seems to us to be the optimal entry-point from which to understand the firm, from the perspective of integrated reporting. Intel describes the company goals as (p. 1 of the Form 10-K) being the preeminent computing solutions company powering the worldwide digital economy, changing the primary focus from the design and manufacture of semiconductor chips for PCs and servers to the delivery of hardware and software platforms, and supporting services. Taking into account the way computing is changing in the context of the internet, Intel seeks to innovate around "three pillars" of computing: energy-efficient performance, connectivity, and security.

Three pillars of computing: Energy-efficient performance, connectivity, and security

The above strategy fuses relevant core drivers of the business and the most salient ESG issues, and the annual report covers all of these dimensions up front (the key point), encompassing products and sales trends, R&D, IP, and

⁸⁸ <http://www.intc.com/annuals.cfm>

compliance with Environmental, Health and Safety regulations within the first few pages. Though the report text highlights the company’s integrated thinking, detail relating to corporate responsibility is generally found outside the Investor area on the website – potentially signalling that it is separate to the main business. We note another nugget hidden at the very end of the report on the Investor Information page, which explicitly states why corporate responsibility creates value for Intel “by helping to mitigate risk, save costs, protect our brand value, and develop new market opportunities” and explains the business case for its corporate strategic objective to “care for our people, care for the planet, and inspire the next generation.” (page 118). In order to keep consistent with the integration messaging, we would expect this explanation to appear more prominently for investors to see.

Intel’s main point of integration turns out to be the Corporate Responsibility Report⁸⁹, linked at the bottom of the Investor Relations landing page. This report purposely mirrors the look and layout of the annual report, particularly in the “Our Business and Integrated Value Approach” section (pages 5-25, and new this year), making it more accessible to those already familiar with the annual report. However, it also goes to great lengths (133 pages, in fact) to document all other ESG factors, initiatives, and GRI data at the company in a very thorough, but somewhat less integrated fashion. This is an all-encompassing report that might be a bit overwhelming to investors and so is best accessed using the online report-builder⁹⁰ where sections can be customised. See details on why Intel chose this approach in the report section entitled on “What Leading Companies Are Doing.”

From the perspective of the financial analyst, we see Intel's financial statement as one of the most user-friendly in the industry group. Intel still does not disclose information that analysts would be keen to see but that the firm regards as sensitive from a competitive positioning perspective, such as number of units produced and utilisation rates of their fabs. We were interested to see that at their analyst day they disclosed some of this information however, suggesting an openness to adjusting what is reported to help the report user.

We see Intel’s financial statement as one of the most user-friendly in the sector

Utilities

As described in the *European ESG Analyser* (June 2011), core drivers for the power industry include resource costs, energy demand growth, and customer relationships. For the power industry, these core drivers indicate that ESG issues run through every aspect of the business, but to different degrees, depending on which stage of the energy food chain (generation, transmission, and services) individual companies are involved in. This is already well-recognised through regulation. Resource costs and energy demand growth are partly determined by the cycle, although from time to time structural issues will come into play. Access to raw materials is also an important medium-term issue.

⁸⁹ <http://www.intel.com/content/www/us/en/corporate-responsibility/corporate-responsibility-report-overview.html>

⁹⁰ <http://www.intel.com/content/www/us/en/corporate-responsibility/csr-report-builder.html>

Table 20: Strategic issues for the sector

| Question | ESG issues – utilities |
|--|---|
| Core drivers | Commodity prices, interest rates, customers, power & gas demand growth. |
| Key metrics | Profit margins, Net debt to EBITDA, FCF. |
| Environmental and social issues that could affect model or metrics | Climate change legislation and other changes to energy policy such as energy efficiency legislation; government policy-led energy demand management in the medium term; security of supply; universal access. |
| Governance issues | Relationship with governments and regulators. |

Source: Adapted from the UBS *European ESG Analyser*, June 2011

American Electric Power

Neutral, PT US\$39.00. UBS analyst: Jim von Rieseemann

At first glance, AEP’s communications seem to emphasise Corporate Citizenship as the primary path for ESG matters, but indeed part of the company’s vision is to be a leader in environmental technology. Specifically, the Vision for Sustainability states, the company intends to be an energy leader through programmes and technologies that protect people, manage impacts on the environment, promote energy efficiency, provide for customer control over usage and provide for greater access to renewable energy and advanced clean energy technologies. The company intends to work with regulators and stakeholders to maximise the positive economic, social and environmental impact of AEP’s operations. This approach likely takes root in AEP President George Tidd’s quote from 1934: “Our job is producing energy and getting it wherever our customers use it – with efficiency and with respect for the environment.”⁹¹

In the latest Company Accountability Report (AEP’s integrated report)⁹², the CEO’s letter likewise goes into detail about competitive advantage, building a sustainable company, and long-term value all in the same breath. In the next breath, he mentions that this is part of the company’s expected 4-6% average annual earnings growth (page 2). The report also references investments in energy efficiency and smart grid as important to providing customer service and to maintaining the business. In fact, in the company’s Form 10-K filing, the MD&A section includes a discussion of environmental regulation and material impacts on the business. There is even a full-page commentary on climate change – this is no surprise following the SEC guidance on climate change risks, but the depth of the focus beyond a passing reference is noteworthy.

AEP is thoroughly addressing climate change and reducing emissions, but it does not quite say why, other than to mention that politically it has lost ground and that it is an act of stewardship. The question remains, why do this for the business? This is succinctly addressed in the Corporate Governance section of the report in an interview with Board members (an interesting spot for it!). Richard Sandor, chair of the Board’s Finance Committee, comments, “AEP is wisely looking at it as a business efficiency issue – getting more by using less.” The company is diversifying its fuel mix, for business and public policy

AEP is addressing climate change and reducing emissions

⁹¹ <http://www.aep.com/about/mission/>

⁹² <http://www.aepsustainability.com/reporting/docs/AEP-CARReport12.pdf>

purposes. From a financial perspective, the company highlights its concern about the size of the capital expenditure it expects to make to comply with environmental regulations, “which forces us to move in a different direction than we had envisioned”. (page 12).

The text of AEP’s report indeed appears fairly integrated. There are separate financial, environmental, and social performance sections in the report, but in the financial/operational performance section, there is a discussion of the internal Environmental Performance Index used in the generation business where annual targets are tied to compensation, for example. Projects for Energy Reliability, Security and Growth are considered in the Business Performance section, but also refer to sustainability too. There is a good set of data represented in the integrated report itself, though specifics supporting the claims of integration being made would be a welcome addition. (Note that the full suite of GRI indicators is available elsewhere on the website for perusal.⁹³)

End-note

Overall, the evidence suggests that the landscape might look quite different in the next couple of years. The IIRC’s pilot-scheme results may become available in 2013, giving us a significant number of road tests of the idea of “one report”. Other firms are likely to continue to develop what they are already doing in the public domain. And we can be sure that between then and now, there will be market challenges designed to test the connectivity of company reports.

⁹³ <http://www.aepsustainability.com/reporting/gri.aspx>

Table 21: Recent regulatory developments by country

| Country | Regulation | Effective date | Source |
|--------------|---|-------------------|--|
| Argentina | Buenos Aires city law 2594/07: All local and international companies in the city with more than 300 employees are required to provide annual social and environmental responsibility reports according to GRI guidelines | January 16, 2008 | Autonomous City of Buenos Aires, http://www.buenosaires.gob.ar/ |
| Australia | Financial Services Reform Act: Issuers of financial products (pension funds, mutual funds, life insurance providers) must provide Product Disclosure Statements on labour standard, environmental, social and ethical considerations | March 11, 2002 | Australian Government, http://www.comlaw.gov.au/Details/C2005C00498 |
| Denmark | Social Responsibility for Large Businesses law (amendment to Financial Statements Act): about 1,100 largest listed public and state-owned companies must disclose corporate responsibility policy within annual report | January 1, 2009 | Danish Commerce and Companies Agency, http://www.csrgov.dk/ |
| Denmark | Executive orders 1305, 1307, and 1310: Pension funds, mutual funds, and insurance providers are required to report on corporate social responsibility alongside the annual report | January 1, 2009 | Danish Commerce and Companies Agency, http://www.csrgov.dk/ |
| EU | Accounting Modernisation Directive 2003/51: European companies must report non-financial performance indicators material to their business, including environmental and employee issues, though countries can make exceptions (e.g. for SME's). Transposed directly into law by Germany, Greece, Hungary, Italy, Netherlands. | January 1, 2005 | European Commission, http://ec.europa.eu/internal_market/accounting/officialdocs_en.htm |
| France | Labour Code: Companies with more than 300 employees must file a bilan social (social balance sheet) on nearly 150 labour and employment indicators | July 12, 1977 | <i>Le Service Public de la Diffusion du Droit</i> , http://www.legifrance.gouv.fr/ |
| France | Reform of Employee Savings Plans and Pension Reserve Funds: Pension funds must identify social, environmental and ethical considerations and how they have been addressed | February 2001 | <i>Le Senat</i> , http://www.senat.fr/ |
| France | Grenelle II Act modifying Article L225-102-1 of the Commercial Code: All listed companies will be required to report environmental and social impacts alongside the annual report (and companies larger than 500 employees will be required as of December 31, 2016) | December 31, 2011 | <i>Le Service Public de la Diffusion du Droit</i> , http://www.legifrance.gouv.fr/ |
| France | Grenelle II Act creating Article L229-25 of the Environmental Code: Companies with more than 500 employees must report greenhouse gas emissions and an emissions reduction plan at least every 3 years | December 31, 2012 | <i>Le Senat</i> , http://www.senat.fr/ |
| Germany | Insurance Supervision Act, Section 115: Private pension funds and life insurance providers must disclose environmental, social, and ethical investment considerations | January 2002 | Federal Financial Supervisory Authority (BaFin), http://www.bafin.de/ |
| India | Securities and Exchange Board of India (SEBI) resolution: Listed companies must report on ESG initiatives through a business responsibility report as part of annual filings (top 100 companies are immediate, while the remaining will be phased in) | November 24, 2011 | SEBI, http://www.sebi.gov.in/cms/sebi_data/pdffiles/22104_t.pdf |
| Malaysia | Malaysian government and Bursa Malaysia stock exchange concurrently established requirements for all public listed companies to disclose CSR practices | December 31, 2007 | Bursa Malaysia, http://www.bursamalaysia.com/website/bm/about_us/the_organisation/csr/approach.html Ministry of Finance Malaysia, http://www.treasury.gov.my/pdf/budget/bs07.pdf |
| Spain | Sustainable Economy Act: Government-sponsored and state-owned companies must file annual corporate governance and sustainability reports | March 6, 2011 | Ministry of the Presidency, http://www.lamanclao.gob.es/ |
| South Africa | Companies listed on the Johannesburg Stock Exchange must submit annual sustainability reports in compliance with King Code of Governance Principles for South Africa 2002 ("King II") | September 1, 2003 | Johannesburg Stock Exchange, http://www.jse.co.za/ |
| South Africa | Companies listed on the Johannesburg Stock Exchange must submit annual integrated reports in compliance with King Code of Governance Principles for South Africa 2009 ("King III") | March 1, 2010 | Johannesburg Stock Exchange, http://www.jse.co.za/ |
| Sweden | Public Pension Funds Act 2000 guidelines: Public pension funds must invest with environmental and ethical considerations without compromising high returns. | January 1, 2001 | Fourth Swedish National Pension Fund (AP4), http://www.ap4.se/web/templates/Page.aspx?id=332 |

| Country | Regulation | Effective date | Source |
|----------------|--|------------------|---|
| Sweden | All 55 state-owned companies must file an annual sustainability report according to GRI guidelines | January 1, 2008 | Regeringskansliet, Government Offices of Sweden, http://www.sweden.gov.se/sb/d/574/a/94125 |
| United Kingdom | Stakeholder Pension Schemes Regulations 2000: Fund managers must provide a statement of the extent of social, environmental, and ethical considerations in investing | October 1, 2000 | The National Archives, http://www.legislation.gov.uk/uksi/2000/1403/made |
| United Kingdom | UK Companies Act 2006, Article 417: Annual Business Review of listed companies must include information on environmental impact, company's employees, and social/community issues as well as relevant policies | October 1, 2007 | The National Archives, http://www.legislation.gov.uk/ukpga/2006/46/section/417 |
| United Kingdom | Climate Change Act 2008: Government must require listed companies to publish carbon emissions annually in the Director's report. | April 6, 2012 | The National Archives, http://www.legislation.gov.uk/ukpga/2008/27/contents |
| United States | EPA's Mandatory Reporting of Greenhouse Gases Rule: Certain large emitters are required to monitor and report GHG data (about 10,000 facilities covering approx. 85% of nation's GHG emissions) | January 1, 2010 | Environmental Protection Agency, http://www.epa.gov/climatechange/emissions/ghgrulemaking.html |
| United States | SEC interpretive Guidance Regarding Disclosure Related to Climate Change: Companies are required to disclose climate-related material risks in their SEC filings | February 8, 2010 | Securities and Exchange Commission, http://www.sec.gov/rules/interp.shtml |
| United States | SEC adoption of Dodd-Frank Bill: Investment managers must report voting record on executive pay ("say on pay") in addition to mutual funds who are already required to disclose | n/a | Securities and Exchange Commission, http://www.sec.gov/spotlight/dodd-frank/corporategovernance.shtml |

Source: UBS, and as stated in the table.

Sustainability reporting glossary

Carbon Disclosure Project (CDP)

<http://www.cdproject.net>

The CDP, a UK-based non-profit project, operates five programmes: Investor CDP, CDP Public Procurement Programme, CDP Water Disclosure, CDP Supply Chain, and CDP Cities. The Investor CDP programme represents 551 institutional investors managing US\$71 trillion of assets, on behalf of which the CDP requests information from the world's largest companies on their climate risks and opportunities. In 2010, about 3,000 companies (of the almost 6,000 asked) disclosed greenhouse gas emissions and climate change strategies via the annual CDP questionnaire as compared to 235 in 2003, when the first survey was distributed.

Climate Disclosures Standards Board (CDSB)

<http://www.cdsb.net/>

The consortium was founded at the World Economic Forum of 2007. With the motto "harmonisation not duplication," the CDSB Climate Change Reporting Framework is not intended to create a new standard, but to increase collaboration and consolidate existing standards and to provide resources for regulators and for companies on disclosure and decision-making. The CDSB's priority is the Consistency Project together with GRI, OECD, and UNCTAD to improve consistency across the supply of – and demand for – climate disclosure. The CCRF Edition 1.0 released in September 2010 is but one iteration of the Framework and the organisation intends to continuously improve towards a more final version over time. The CDP acts as the Secretariat to the CDSB, which is also made up of Ceres, The Climate Group, The Climate Registry, International Emissions Trading Association, World Council for Business and Sustainable Development, World Economic Forum, and World Resources Institute.

Corporate Sustainability Reporting Coalition (CSRC)

This coalition of 40 investors (managing cUS\$2 trillion) was convened by Aviva in autumn 2011 to lobby for United Nations member states to adopt at the 2012 Earth Summit a binding international commitment to develop national regulations that: (1) mandate the integration of material sustainability issues in the annual report and accounts; and (2) provide effective mechanisms for investors to hold companies to account on the quality of their disclosures, including, for instance, through an advisory vote at the AGM.⁹⁴

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<http://www.aviva.com/data/media-uploads/news/File/Towards%20a%20convention%20on%20corporate%20sustainability%20reporting%20at%20Rio+20.pdf>

EPRA – Sustainability Reporting Committee

<http://www.epra.com/>

The European Public Real Estate Association (EPRA) comments that sustainability performance reporting is an area of increasing interest for investors in listed property companies. EPRA is actively influencing this debate through several initiatives, including the development of Sustainability BPR and guidance for European listed property companies.⁹⁵ The EPRA has issued Best Practice Guidelines in respect of what should be reported in the areas of energy, greenhouse gas emissions, water and waste.⁹⁶

Global Initiative for Sustainability Ratings (GISR)

<http://ratesustainability.org/>

This initiative was founded by Ceres and Tellus Institute in 2011 in order to convene a ratings framework for company sustainability performance and was modelled after GRI. By augmenting the presence of sustainability content in mainstream ratings approaches, GISR expects to influence the flow of capital towards companies truly leading in sustainability. Initially, the focus will be on cross-sectoral standards and subsequently on sector-specific applications, with a beta version targeted by end of 2012. The ultimate goal is for the ratings of all asset classes to eventually integrate such information into a new form of “integrated ratings.”

Global Reporting Initiative (GRI)

<https://www.globalreporting.org/>

This initiative was founded by Ceres and Tellus Institute in 1997 in order to make companies accountable for their environmental performance. The Sustainability Reporting Framework provides companies a standardised set of principles and indicators by which to measure and report economic, environmental, social, and governmental performance. There have been three generations of guidelines with the first launching in 2000, the second in 2002, and the latest in 2006. A revision of the last version was released in March 2011 as the G3.1 Guidelines which augmented reporting on gender, community, and human rights.

International Integrated Reporting Council (IIRC)

<http://www.theiirc.org/>

In 2010, the Prince’s Accounting for Sustainability Project (A4S) and the GRI formed this group to create a global framework for sustainability accounting. The supporting Working Group is made up of 25 leaders in business, accounting, academia, investment, and non- and inter-governmental organisations. In 2011, the Council released a Discussion Paper⁹⁷ for public consultation and launched a

⁹⁵ <http://www.epra.com/regulation-and-reporting/sustainability/>

⁹⁶ <http://www.epra.com/main-news-tree/pr-template4/>

⁹⁷ http://theiirc.org/wp-content/uploads/2011/09/IR-Discussion-Paper-2011_spreads.pdf

Pilot Programme with over 60 companies now midway through the first reporting cycle on the basis of the draft Integrated Reporting Framework.

Integrated Report

By making explicit the connection between financial and ESG performance, an integrated report is meant to serve as a company's single annual report for the benefit of all investors and stakeholders.

Prince's Accounting for Sustainability Project (A4S)

<http://www.accountingforsustainability.org/>

In 2004, HRH The Prince of Wales started this project to develop tools and guidance that will entrench long-term sustainability into organisational decision making. The Project's outputs, the first of which were released in 2006, are in the form of research reports, formal networks, a microsite, a forum, and others created in partnership with businesses, investors, public sector, accounting bodies, NGOs and academics. One of the four current priorities for the Project is integrated reporting, which includes continued work on the formation of the IIRC (described above).

Sustainability Accounting Standards Board (SASB)

<http://www.sasb.org/>

Modelled after the Financial Accounting Standards Board (FASB), this US-based organisation is currently in early stages of developing accounting standards and industry-based indicators for companies to report ESG performance. To start, SASB will investigate the materiality of sustainability risks and opportunities and, on that basis, create a map that prioritises sustainability issues by industry as well as establishing a set of key performance indicators by industry that should be reported in Form 10-K or similar standardised filings. The preliminary versions of each should be complete by Q2 and Q4 of 2012, respectively. Ultimately, the goal is for the SEC to acknowledge SASB as the authority on materiality and disclosure of sustainability issues.⁹⁸

Triple Bottom Line

This concept extends the traditional bottom line measure of company performance from just a measurement of economic value to also include social and environmental value.

UN Principles for Responsible Investment (PRI)

<http://www.unpri.org/>

This set of six investing principles is agreed upon by institutional investors who pledge to uphold them as a fulfilment of their fiduciary, duty given that they consider ESG factors to have a material effect on portfolio performance:

- We will incorporate ESG issues into investment analysis and decision-making processes.

⁹⁸ Erika Karp, UBS's Head of Global Sector Research, is a member of the SASB Board.

- We will be active owners and incorporate ESG issues into our ownership policies and practices.
- We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- We will promote acceptance and implementation of the Principles within the investment industry.
- We will work together to enhance our effectiveness in implementing the Principles.
- We will each report on our activities and progress towards implementing the Principles.

The Principles were drawn up together by 20 institutional investors from 12 countries, supported by 70 experts over the course of several deliberations between 2005 and 2006. Now, more than 1,000 investment institutions representing US\$32 trillion are signatories to the PRI, as of June 2012.

We would like to thank...

We would like to thank the following people for their willingness to spend time talking to us, providing perspectives that added breadth to this report. All errors and omissions are the responsibility of the UBS Global Sustainability Team.

- Nelmara Arbex, Deputy Chief Executive, GRI
- Amra Balic, Head of Corporate Governance and Responsible Investment (CGRI) in EMEA, BlackRock
- Wim Bartels, Partner, Global Head Sustainability Assurance, KPMG
- Aaron Bernstein, Senior Research Associate, Labor and Worklife Program, Harvard Law School
- Bruno Bertocci, Global Equity Portfolio Manager, UBS Global Asset Management
- Mick Blowfield, Senior Fellow, Smith School, Oxford University
- Steve Cooper, IASB Board Member and former Head of Global Valuation, UBS, IASB
- Aron Cramer, President and CEO, BSR
- Paul Druckman, CEO, IIRC
- Robert Eccles, Professor of Management Practice, Harvard Business School
- Suzanne Fallender, Director of CSR Strategy and Communications, Intel
- Jessica Fries, Director, Corporate Reporting, Sustainability and Climate Change, PwC
- Sean Gilbert, Director, Climate Change and Sustainability, KPMG Advisory (China) Limited
- Kimberly Gladman, Director of Research and Risk Analytics, GMI Ratings
- Herve Guez, Head of ESG research and engagement, Natixis Asset Management
- Shana Harbour, Deputy Director, Integrated Environmental Strategies Division, US EPA
- Eric Hespenheide, Partner, Global Leader, Business Risk, Deloitte & Touche
- Bozena Jankowska, Global Head of Sustainability Research, RCM
- Alya Kayal, Director of Policy and Programs, US SIF
- Claudia Kruse, Head of Governance, APG

- Mindy Lubber, President of Ceres and Director of INCR, IIRC member, Ceres
- Sandy Nessing, Managing Director, Sustainability & ESH Strategy & Design, AEP
- Iain Richards, Head of Governance and Responsible Investment, Threadneedle
- Jean Rogers, Executive Director and Founder, SASB
- Elizabeth Seeger, Principal, KKR
- Howard Sherman, Executive Director, GMI Ratings
- Brian Singleton-Green, Manager, Corporate Reporting, ICAEW
- Nigel Sleigh-Johnson, Head of Financial Reporting Faculty, ICAEW
- Ivar Smits, Manager of Investor Relations, AkzoNobel
- Susanne Stormer, Vice President of Corporate Sustainability, Novo Nordisk
- Elizabeth Strokes, Sustainability Director, AkzoNobel
- Mark Tulay, Program Director, GISR
- Stephanie Wettberg, Vice President Corporate Communications, BASF SE
- Christy Wood, Chairman, Board of Governors, ICGN

■ Statement of Risk

The immediate risk in relation to the subject-matter covered by UBS's Global Sustainability Team arises from the lack of definition in the field, reflected in the many names and acronyms in use by practitioners: Sustainability; Responsible Investment (RI); Socially Responsible Investment (SRI); ESG (Environmental, Social and Governance) Investment; Ethical Investing, Impact Investing and so on. The field covers an enormous range of potential issues, and, over time, their importance fluctuates. At the time of writing, we believe the issues raised in this research to be relevant to investors, but this may change. Additionally, this research should not be read as a complete or definitive account of all relevant issues for firms. Although we attempt to address all significant or nascent issues, these may not always be apparent, and these may change over time. Finally, this document should not be interpreted to mean that all the issues addressed in our research have a financial impact. Whether or not environmental, social and governance issues have a financial impact remains an open question as there is no accepted financial model that can determine whether any given issue - ESG or otherwise - is already reflected in share prices.

■ Analyst Certification

Each research analyst primarily responsible for the content of this research report, in whole or in part, certifies that with respect to each security or issuer that the analyst covered in this report: (1) all of the views expressed accurately reflect his or her personal views about those securities or issuers and were prepared in an independent manner, including with respect to UBS, and (2) no part of his or her compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views expressed by that research analyst in the research report.

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UBS Investment Research: Global Equity Rating Allocations

| UBS 12-Month Rating | Rating Category | Coverage ¹ | IB Services ² |
|-----------------------|-----------------|-----------------------|--------------------------|
| Buy | Buy | 51% | 34% |
| Neutral | Hold/Neutral | 40% | 35% |
| Sell | Sell | 9% | 15% |
| UBS Short-Term Rating | Rating Category | Coverage ³ | IB Services ⁴ |
| Buy | Buy | less than 1% | 25% |
| Sell | Sell | less than 1% | 17% |

1:Percentage of companies under coverage globally within the 12-month rating category.

2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

3:Percentage of companies under coverage globally within the Short-Term rating category.

4:Percentage of companies within the Short-Term rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS. Rating allocations are as of 31 March 2012.

UBS Investment Research: Global Equity Rating Definitions

| UBS 12-Month Rating | Definition |
|-----------------------|---|
| Buy | FSR is > 6% above the MRA. |
| Neutral | FSR is between -6% and 6% of the MRA. |
| Sell | FSR is > 6% below the MRA. |
| UBS Short-Term Rating | Definition |
| Buy | Buy: Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event. |
| Sell | Sell: Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event. |

KEY DEFINITIONS

Forecast Stock Return (FSR) is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

Market Return Assumption (MRA) is defined as the one-year local market interest rate plus 5% (a proxy for, and not a forecast of, the equity risk premium).

Under Review (UR) Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

Short-Term Ratings reflect the expected near-term (up to three months) performance of the stock and do not reflect any change in the fundamental view or investment case.

Equity Price Targets have an investment horizon of 12 months.

EXCEPTIONS AND SPECIAL CASES

UK and European Investment Fund ratings and definitions are: Buy: Positive on factors such as structure, management, performance record, discount; Neutral: Neutral on factors such as structure, management, performance record, discount; Sell: Negative on factors such as structure, management, performance record, discount.

Core Banding Exceptions (CBE): Exceptions to the standard +/-6% bands may be granted by the Investment Review Committee (IRC). Factors considered by the IRC include the stock's volatility and the credit spread of the respective company's debt. As a result, stocks deemed to be very high or low risk may be subject to higher or lower bands as they relate to the rating. When such exceptions apply, they will be identified in the Company Disclosures table in the relevant research piece.

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UBS Limited: Julie Hudson, CFA; Hubert Jeaneau. **UBS Securities LLC:** Eva Tiffany Zlotnicka.

Company Disclosures

| Company Name | Reuters | 12-mo rating | Short-term rating | Price | Price date |
|---|----------|---------------|-------------------|------------|-------------|
| Akzo Nobel ^{16, 22} | AKZO.AS | Sell | N/A | €37.47 | 18 Jun 2012 |
| American Electric Power, Inc. ^{2, 4, 5, 6a, 6b, 6c, 7, 16} | AEP.N | Neutral | N/A | US\$40.07 | 18 Jun 2012 |
| AstraZeneca ^{4, 6a, 16, 22} | AZN.L | Buy | N/A | 2,683p | 18 Jun 2012 |
| BASF SE ^{5, 14, 16} | BASFn.F | Neutral | N/A | €56.16 | 18 Jun 2012 |
| Beiersdorf | BEIG.F | Neutral | N/A | €52.68 | 18 Jun 2012 |
| BHP Billiton Plc ^{2, 3a, 4, 5, 6a, 16} | BLT.L | Buy | N/A | 1,829p | 18 Jun 2012 |
| BlackRock, Inc. ^{2, 4, 5, 6a, 6b, 6c, 7, 16} | BLK.N | Buy | N/A | US\$173.45 | 18 Jun 2012 |
| Coca-Cola Co. ^{2, 4, 5, 6a, 6b, 6c, 7, 16} | KO.N | Neutral | N/A | US\$75.98 | 18 Jun 2012 |
| Colruyt ¹⁶ | COLR.BR | Sell | N/A | €31.84 | 18 Jun 2012 |
| Danone ¹⁶ | DANO.PA | Neutral | N/A | €51.83 | 18 Jun 2012 |
| Diageo ^{4, 5, 14, 16} | DGE.L | Buy | N/A | 1,602p | 18 Jun 2012 |
| General Electric Co. ^{3b, 4, 5, 6a, 6b, 6c, 7, 16, 18a, 22} | GE.N | Buy | N/A | US\$19.75 | 18 Jun 2012 |
| Henkel ¹⁶ | HNKG_p.F | Neutral | N/A | €52.08 | 18 Jun 2012 |
| Intel Corp. ^{4, 5, 6b, 6c, 7, 8, 16, 18b} | INTC.O | Buy | N/A | US\$27.42 | 18 Jun 2012 |
| Kingfisher ^{4, 16} | KGF.L | Buy | N/A | 273p | 18 Jun 2012 |
| Lanxess AG ⁵ | LXSG.DE | Neutral | N/A | €50.31 | 18 Jun 2012 |
| L'Oréal ¹⁶ | OREP.PA | Buy | N/A | €91.33 | 18 Jun 2012 |
| Natixis | CNAT.PA | Not Rated | N/A | €1.98 | 18 Jun 2012 |
| Natura Cosmeticos SA ²⁰ | NATU3.SA | Neutral (CBE) | N/A | R\$45.19 | 18 Jun 2012 |
| Novo Nordisk ¹⁶ | NOVOb.CO | Neutral | N/A | DKr813.00 | 18 Jun 2012 |
| Novozymes A/S ¹⁶ | NZYMb.CO | Neutral | N/A | DKr161.10 | 18 Jun 2012 |
| PepsiCo Inc. ^{4, 5, 6a, 6b, 6c, 7, 16, 18c} | PEP.N | Neutral | N/A | US\$69.60 | 18 Jun 2012 |
| Puma SE | PUMG.DE | Neutral | N/A | €238.35 | 18 Jun 2012 |
| Rio Tinto Plc ^{2, 4, 6a, 16, 22} | RIO.L | Buy | N/A | 2,963p | 18 Jun 2012 |
| Solvay ¹⁶ | SOLB.BR | Buy | N/A | €78.64 | 18 Jun 2012 |
| Southwest Airlines ^{16, 22} | LUV.N | Neutral | N/A | US\$9.03 | 18 Jun 2012 |
| Umicore | UMI.BR | Buy | N/A | €37.30 | 18 Jun 2012 |
| Unilever Plc ^{4, 5, 14, 16} | ULVR.L | Neutral | N/A | 2,087p | 18 Jun 2012 |
| Verbund AG ^{4, 16} | VERB.VI | Sell | N/A | €18.80 | 18 Jun 2012 |

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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