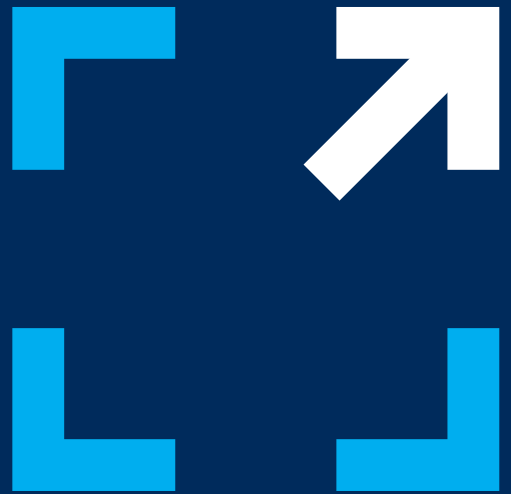


ENHANCING INTEGRATED REPORTING

INTERNAL AUDIT VALUE PROPOSITION



**The Institute of
Internal Auditors**

*France
Netherlands
Norway
Spain
UK and Ireland*

This publication is released by European institutes of internal auditors (**IIA France, IIA Netherlands, IIA Norway, IIA Spain, IIA UK and Ireland**) with the valuable contribution of **IIA Global** and the **IIRC**.

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Briefing for board and senior management*



About this paper

Integrated Reporting is a new development with multiple challenges. A European task force was initiated in April 2014 by several institutes¹, affiliates of the Institute of Internal Auditors (the IIA), to clarify why and how internal auditors can help build an efficient integrated reporting process and meet the needs for assurance.

The task force recommendations are not mandatory. They are based on the International Professional Practices Framework (IPPF) of the IIA and a literature review on <IR>.

Each section of the <IR> Framework, the market led and principles-based initiative of the International Integrated Reporting Council (IIRC), has been reviewed to:

- highlight the concepts, principles and content elements recommended by the IIRC;
- identify potential challenges to and enablers of the implementation of these recommendations;
- clarify the underlying governance, risk and control issues;
- discuss internal audit's assurance and advisory role;
- share good practices. For example, regarding coordination with other functions.

The briefing gives an overview of this research to those charged with governance and senior management.

The guide provides actionable recommendations for internal audit and risk practitioners.

¹ IIA France (IFACI), IIA Spain (IAI), IIA Netherlands, IIA Norway, IIA UK & Ireland

About the integrated reporting quake

Reporting culture has changed significantly in the last decades. Mandatory or voluntary requirements around financial and non-financial reporting (such as European and national regulations, stock exchange authorities' recommendations) are increasing. Organizations are producing different reports to meet external demand from providers of financial capital, rating agencies, customers, citizens, etc. Moreover, in a time of resource constraints and intensified competition, organizations are looking for sustainable business performance and a close relationship with their stakeholders.

<IR> is a process founded on integrated thinking that results in a periodic integrated report. By focusing on achievement of organizational objectives over time and related communications, <IR> is a critical process in this context, it helps the company report the overall value creation story.

"An integrated report explains how an organization creates value over time. It therefore aims to provide insight about:

- *The external environment that affects an organization*
- *The "capitals" (resources and the relationships used and affected by the organization), whether they are financial, manufactured, intellectual, human, social and relationship, and natural*
- *How the organization interacts with the external environment and the capitals to create value over the short, medium and long term."*

From, The International <IR> Framework. The IIRC (2013), p10

About the role of internal audit

While it is not internal audit's responsibility to determine specifically what must be disclosed or to design the underlying disclosure processes, it can be a key player in this new initiative.

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

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

From Integrated reporting and the emerging role of internal auditing. The IIA (2013b)

The IIA's code of ethics promotes an ethical culture among internal auditors. It helps them support the integrity and transparency underlying <IR>.

Internal audit professionals routinely interact closely with key players that are central to an organization's integrated reporting process. With its organizational independence as well as a sound understanding of the business and its environment, internal audit can play several roles depending on the maturity of the reporting processes and on the road map of the organization towards integrated reporting.

EXECUTIVE SUMMARY

Internal audit's assurance role can be achieved via different types of engagements such as: an assurance on the integrated report, a focus on governance, risk management and control processes supporting the main objectives of integrated reporting. However, internal audit's involvement is not limited to the assessment of the due process of reporting. It should also provide an independent assurance on the reliability of the facts and figures included in the report as well as ascertain the existence of an integrated thinking culture within the organization.

As counsellor, internal audit can also provide advice and insights, especially when organizations are in the early stages of building their integrated reporting/thinking processes. As part of good governance, this role can take several focuses such as: advocating the value of <IR>, facilitating process design and control during the roll out phase, fostering integrated thinking, etc. In addition, the chief audit executive must determine the level of reliance on other internal assurance providers (such as risk management, internal control, information security, quality management, safety and environment, etc.). Relevant work performed by others should be leveraged.

Internal audit should foster the development of an integrated reporting approach and be involved from day one. Chief audit executives must be proactive in anticipating the demands of those charged with governance and sustaining integrated thinking.

Why my organization should evolve toward this new reporting initiative?

Organizations must be aware of and understand the increasing and evolving demands of corporate reporting and be prepared to adapt their internal structure to produce reliable, decision-useful information. With its focus on an organization's value creation over the short-, medium-, and long-term, Integrated Reporting (<IR>) provides a unique opportunity for development and improvement in the way that information is managed and reported both internally and externally. Properly designed and effectively implemented, <IR> represents the next step in the evolution of corporate reporting. Beside its external benefits <IR>, when properly designed and effectively implemented, can be a management tool for monitoring the external environment and coordinating organizational efforts.

What is integrated reporting?

The IIRC released the International Integrated Reporting Framework in December 2013. This was a key milestone in the journey towards greater cohesion and efficiency in reporting processes.

The Framework focuses on value creation over time based on different types of 'capitals' not limited to financial resources. The ambition goes far beyond the compilation of existing external reporting. The ultimate aim is to highlight the ways the organization leverages its 'capitals' by interconnecting their effects. The process is based on an "integrated thinking" state of mind across the organization, which means breaking down internal silos as a way of enhancing the organization's overall performance.

By providing the principles and entry points for <IR>, the Framework helps improve the quality of information available to financial capital providers and other stakeholders.

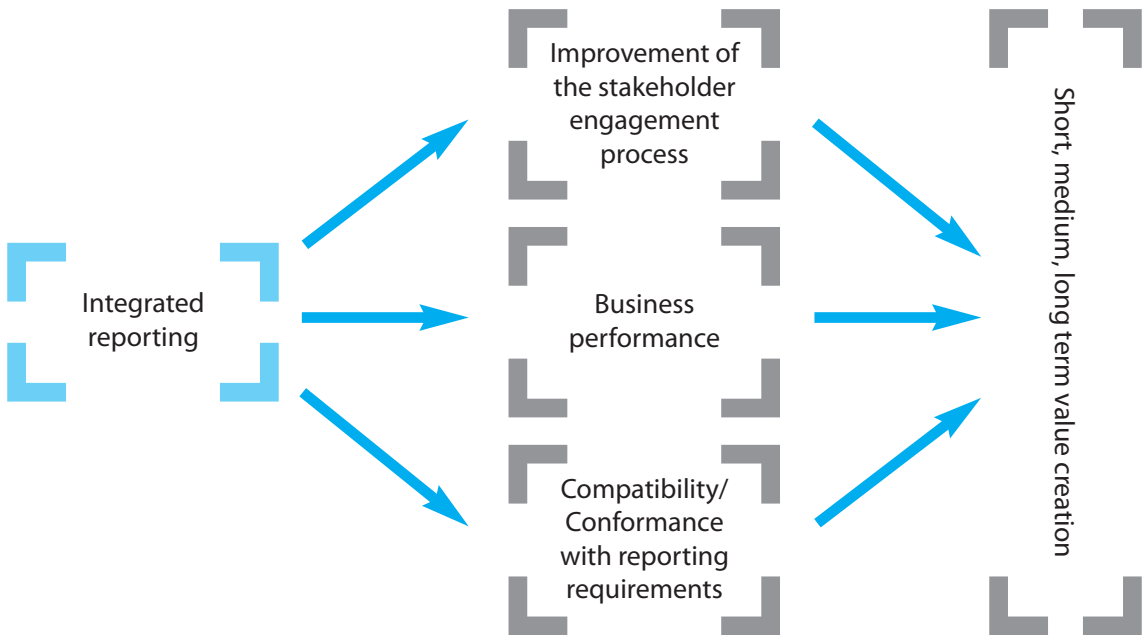
Internally, it sustains more efficient and productive allocation of the different capitals as well as sound risk and opportunity management.

For more details : www.theiirc.org



FREQUENT QUESTIONS ABOUT
INTEGRATED REPORTING (<IR>)

The potential benefits of <IR> are diverse² (Eccles and Armbrester, 2011; ACCA, 2014; Crutzen, 2014):



■ **Improvement of the stakeholder engagement process:**

<IR> contributes to better relations with all stakeholders and greater understanding of their expectations. Key stakeholders such as providers of financial capital, analysts and data vendors seek accurate information. Typically this concerns information that is not wholly reflected in the financial accounts because of the intangible value of certain capitals.

In addition, this engagement process has market side effects in terms of reduction of cost of capital, competitiveness, communication with different categories of customers, reduction of supply-chain risks due to interactions with vendors and enhancement of the organization’s reputation and brand.

■ **Business performance:** <IR> process helps a better understanding of the key performance indicators reflecting the organization’s business model and strategy, as well as

Pioneers’ motivations for implementing <IR> are to:

- *undo the inefficiencies of having separate reports and reporting processes;*
- *break down corporate silos and inspire more joined-up thinking;*
- *provide stakeholders with a one-stop-shop corporate narrative regarding value creation and performance on material issues;*
- *be logical and natural when sustainability is already embedded in their core business.*

From GRI (2013), The sustainability content of integrated reports – a survey of pioneers.

² Cf. *Understanding transformation: Building the business case for Integrated Reporting (IIRC, 2002) and Realizing the benefits: The impact of Integrated Reporting (IIRC, 2014).*

the execution of this strategy. These metrics can be shared by different functions to improve decision making and capital allocation. It contributes to the enhancement of risk management systems by aligning the organization's risks more closely with its opportunities.

As <IR> conveys corporate values, it also has positive impacts on current and prospective employees' performance³.

■ **Compatibility/conformance with internal and external reporting requirements.**

Organizations are facing increasing demand for financial and non-financial reporting. Whether contractual or regulatory, organizations should be prepared to fulfill these reporting requirements and provide assurance to those charged with governance.

All these benefits contribute to short, medium and long term value creation. <IR> is intended to become a pillar for the reputation of the organization and an opportunity to reveal the intangibles.

Why is “integrated thinking” important?

External reporting is only one of the outcomes of <IR> (Giovannoni E. and Fabietti G, 2013). To maintain the process and for a genuine linkage with value creation, <IR> should be embedded in the business through “integrated thinking” which is the way to more meaningful management through:

- effective knowledge management between key players (directors, executive and operational managers, financial and sustainability reporters, risk managers, internal auditors, etc.);

- alignment with other management tools (such as business plans, balanced scorecards, budgeting systems, tracking and reporting tools on social and environmental issues, quality management systems, etc.);
- development of ad hoc management systems to overcome silo-thinking.

Integrated thinking is a field where internal audit can be instrumental in disseminating its broad knowledge of the organization and leveraging its close interactions with the different key players of <IR>.

Integrated thinking is the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organization uses or affects.

Integrating thinking leads to integrated decision-making and actions that consider the creation of value over the short, medium and long term.

Assurance on <IR>: an introduction to the discussion. The IIRC (2014), p 5.⁴

³ cf. www.theiirc.org for research papers on the positive impacts of <IR> on employees.

⁴ This paper was released in July 2014 by the IIRC “in order to debate the practical and technical challenges in ensuring credibility and trust in <IR>. A summary of the feedback received will be published by the IIRC in early 2015.

How is <IR> different?

	Financial reporting >>	Integrated reporting
Thinking	Isolated >>	Integrated
Stewardship	Financial capital >>	All forms of capital
Focus	Past, financial >>	Past and future, connected, strategic
Timeframe	Short term >>	Short, medium and long term
Trust	Narrow disclosures >>	Greater transparency
Adaptive	Rule bound >>	Responsive to individual circumstances
Concise	Long and complex >>	Concise and material
Technology enabled	Paper based	Technology enabled

For more details: *Towards Integrated Reporting. The IIRC (2011)*

What should be my role as a board member or senior manager?

Those charged with governance need to be especially involved in <IR>.

They are responsible for setting the reporting strategy (goals, level of aggregation, main users, milestones, etc.) and governance (key players, oversight structure, integrity and ethical values, etc.) of the organization. *Their involvement prevents <IR> from being an empty mechanism with no value for the business. In this way, they foster:*

- tone at the top regarding transparency and accountability;
- integrated thinking in operational and strategic decisions;
- a broad view of all the capitals needed and available for value creation;
- a proper governance structure with defined roles for relevant board committees;
- engagement with strategic stakeholders;
- anticipation of external reporting requirements and change needed within the organization;
- clarification of the responsibilities of internal assurance functions.

As <IR> is principle based, *the direction set by board members and senior management is critical for the definition of each organization's ambition, structures, procedures and level of assurance needed. Accordingly, they should in particular clarify their expectations regarding internal audit activity and its involvement at the very early stage of an <IR> approach.*



BRIEFING FOR BOARD MEMBERS AND SENIOR MANAGEMENT

What could be the potential challenges?

The main challenge of <IR> is to really embed the core concepts and principles within the organization. Moreover the mood of integrated report leads to move forward over some existing practices (mandatory reporting constraints, "business secret", etc.) since it addresses the operational performance.

Due to existing reporting habits, some can be difficult to implement (such as the reporting of value creation based on intangibles, conciseness vs. completeness, transparency vs. competitiveness, reporting constraints vs. operational performance, etc.).

A reporting strategy should be established and periodically revised to determine the right balance as regards:

- the scope and supporting information of the organization's integrated report;
- communication of long term objectives or sensitive information on strategy;
- management of several business models due to diverse markets and production areas;
- comparability without established and shared standards for each type of capital;
- the processes ensuring the quality of disclosures;
- the level of assurance needed;
- materiality, particularly for non-financial risks.

Sound governance, risk management and control processes are fundamental enablers of <IR>.

Recognized frameworks such as COSO ERM (Enterprise Risk Management) and IC (Internal control) must be leveraged.

For more information, visit: www.coso.org

Which key functions are involved?

Due to its internal control, risk management and governance issues, the "three line of defense" model can contribute to the implementation and enhancement of <IR>.

The three lines of defense model distinguishes among three groups (or lines):

- **Functions that own and manage risks.** They also are responsible for implementing corrective actions to address process and control deficiencies.
- **Functions that oversee risks.** Their role includes assisting management in developing processes and controls. Relevant second line of defense functions for <IR> are: risk management, internal control, legal, finance, controlling, IT, HR, investor relations, sustainability, quality management, customer satisfaction, safety and environment, etc.
- **Functions that provide independent assurance.** Based on the highest level of independence and objectivity within the organization, internal audit provides assurance on the effectiveness of governance, risk management, and internal controls, including the manner in which the first and second lines of defense achieve risk management and control objectives.

Reliable work (monitoring tools, self-assessments, tests) performed by the second line of defense should be used by internal auditors. This coordination can take the form of joint audits, discussion of work papers, shared risk assessments, promotion of the work done by others, etc.

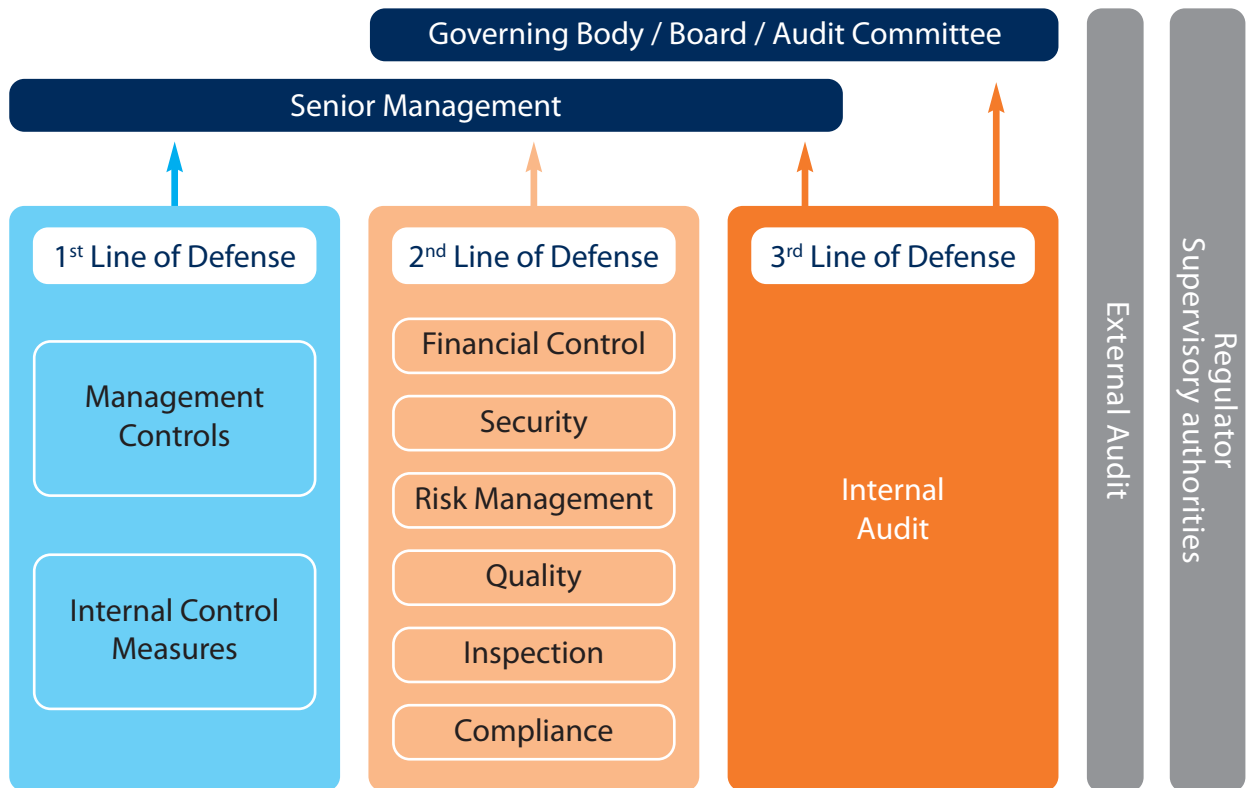
As part of its natural contribution to the organization's value creation, internal audit has several reasons to take part in <IR>. Indeed, internal audit's role and positioning is closely aligned with <IR> objectives such as:

- holistic understanding of the organization's strategy and performance;
- engagements regarding the different type of capitals;
- close interactions with a broad range of internal and external stakeholders;

- connectivity and reliability of information which becomes critical as disclosures need to be more and more precise.

<IR> can be time and resource consuming. For organizations seeking a more effective and efficient approach, internal audit can be instrumental in the implementation of this new initiative.

The Three Lines of Defense Model



IIA (2013a). Position paper, *The three lines of defense in effective risk management and control*.

10 questions board members and senior management should ask their chief audit executive

1. **What is the demand (mandatory or voluntary) for integrated reports?**
2. **What is the chief audit executive's knowledge of the organization's <IR> strategy?**
3. **What is internal audit's role in the existing disclosure mechanisms?**
 - Responsibilities regarding different kinds of internal and external reporting (financial, sustainability, corporate governance, remuneration, etc.).
4. **How does internal audit understand its existing and future role around <IR>?**
 - Is this role part of a formalized internal audit strategy?
 - Are any new engagements planned in this area?
 - Has internal audit considered the significant risks related to <IR> while developing its audit plan?
5. **Is internal audit well positioned with sufficient scope for this new role?**
 - Is the interaction with those charged with governance sufficient?
 - What is internal audit's coverage of the organization's stakeholders map and reporting scope?
6. **Are internal audit resources adequate for this strategic role?**
 - Is the internal audit activity's sourcing strategy aligned with <IR> issues?
 - Do internal audit staff have sufficient knowledge of the organization's complexity to deal with connectivity issues?
 - What about soft skills (ability to listen, critical thinking, etc.)?
 - Is the internal audit budget sufficient to have the number of staff needed for an appropriate coverage of the scope?
7. **How does internal audit manage potential impairments to objectivity?** For example, in the case of:
 - an assurance engagement following an advisory role;
 - reliance on other assurance providers.
8. **Is the quality assessment program in conformance with professional standards?**
9. **How does internal audit facilitate "integrated thinking"?**
10. **How does internal audit coordinate with second line of defense functions?**
 - What is the assurance map of the <IR> process?

ENHANCING INTEGRATED REPORTING

*A GUIDE FOR INTERNAL AUDIT
AND RISK PRACTITIONERS*



This paper is released with a shorter briefing that provides an overview of <IR> issues for senior management and those charged with governance.

The task force proposals follow the structure of the <IR> Framework with:

- **Three fundamental concepts:**
 - value creation over time;
 - capitals (financial, manufactured, intellectual, human, social and relationship, and natural capital);
 - value creation process.

- **Seven guiding principles**, articulated by the task force around three categories for the purposes of this discussion:

Point of focus of the task force	<IR> guiding principles recommended by the IIRC
<u>Strategy and connectivity</u>	<ul style="list-style-type: none"> • <u>Strategic focus and future orientation</u> • <u>Connectivity of information</u>
<u>Significance and accessibility</u>	<ul style="list-style-type: none"> • <u>Stakeholder relationships</u> • <u>Materiality</u> • <u>Conciseness</u>
<u>Soundness and fairness</u>	<ul style="list-style-type: none"> • <u>Reliability and completeness</u> • <u>Consistency and comparability</u>

- **Seven content elements**⁵, also articulated by the task force around three categories for the purposes of this discussion:

Point of focus of the task force	<IR> content elements recommended by the IIRC
<u>Context and structures for value creation</u>	<ul style="list-style-type: none"> • <u>Organizational overview and external environment</u> • <u>Governance</u> • <u>Business model</u>
<u>Goals and outcomes monitoring</u>	<ul style="list-style-type: none"> • <u>Strategy and resource allocation</u> • <u>Performance</u>
<u>Dealing with the effects of uncertainty</u>	<ul style="list-style-type: none"> • <u>Risks and opportunities</u> • <u>Outlook</u>

⁵ The content elements: "Basis of preparation and presentation" and "General reporting guidance" are discussed throughout the document.



A GUIDE FOR INTERNAL AUDIT AND RISK PRACTITIONERS

With its broader scope, <IR> concepts and principles raise potential challenges for organizations. **This document highlights various ways in which internal audit can add value by enhancing the content of the integrated report and the <IR> process as a whole.**

Indeed internal audit is well suited to providing a broad range of assurance and advisory services (see appendix 2 “The <IR> fan”). Internal auditors add value by performing engagements in conformance with the professional principles of the IIA’s code of ethics and standards.

Regarding the reporting process, internal audit can answer such questions as:

1. What are the existing governance, risk management and control processes to be leveraged by the organization for <IR> purposes?
2. Does the scope of the <IR> process adequately cover the material activities, capitals (including externalized resources) and stakeholders?
3. Is the underlying process for the production of the integrated report adequate?
4. Does the <IR> scope reflect the organization’s reporting strategy?
5. Is the information conveyed in the integrated report reliable?
6. What is the level of understanding of <IR> concepts and principles within the organization?
7. Are key information providers to the integrated report (such as the risk management function, investor relations, financial and sustainability reporting preparers) strategically aligned and future focused?
8. Are the responsibilities of the functions involved in the <IR> process clearly defined? Are communication lines effective?
9. How is connectivity taken into account in the organization’s IT governance?
10. Is financial and non-financial information correctly linked in the organization’s value creation process? And in its external communication?
11. Is the information on the nature and the materiality of the interactions with stakeholders for the value creation process over time reliable?
12. Is web technology sufficiently leveraged for effective communication with stakeholders?
13. Does the process of selecting the organization’s key stakeholders reflect capital ownerships and emerging trends?
14. Are the organization’s responses to significant crises impacting key stakeholders adequate?
15. Do materiality determination processes ensure consistency between the organization’s value creation model and the risk criteria (risk appetite, risk tolerance threshold, etc.) defined in its risk management system?
16. Are materiality thresholds taken into account in decision making and in interactions with key stakeholders?
17. Are material issues excluded (intentionally or otherwise) from the report?
18. How are cross-references to internal and external sources managed and monitored?
19. Does the report adequately balance conciseness and completeness?
20. Are the standards and rules adopted by the organization relevant as regards its reporting strategy and regulatory requirements? Are they effectively used across the organization?

Following a discussion of <IR> concepts and principles, a number of recommendations for the evaluation of the content elements suggested by the IIRC are set out hereafter.

In this section we will focus on the concepts and principles developed by the IIRC and discuss a number of potential challenges and enablers for chief audit executives.

<IR> fundamental concepts

The fundamental concepts underpin and reinforce the requirements and guidance in the <IR> Framework.

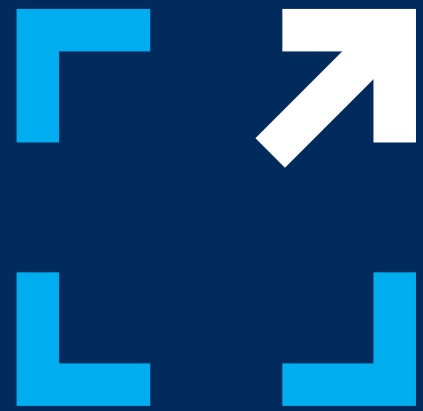
The <IR> Framework states that *“the ability of an organization to create value for itself is linked to the value it creates for others.”*

Therefore organizations should report on how they interact with the external environment and use different combinations of capitals to create value over time for different sets of stakeholders. The capitals identified in the Framework are **financial, manufactured, intellectual, human, social and relationship, and natural.**

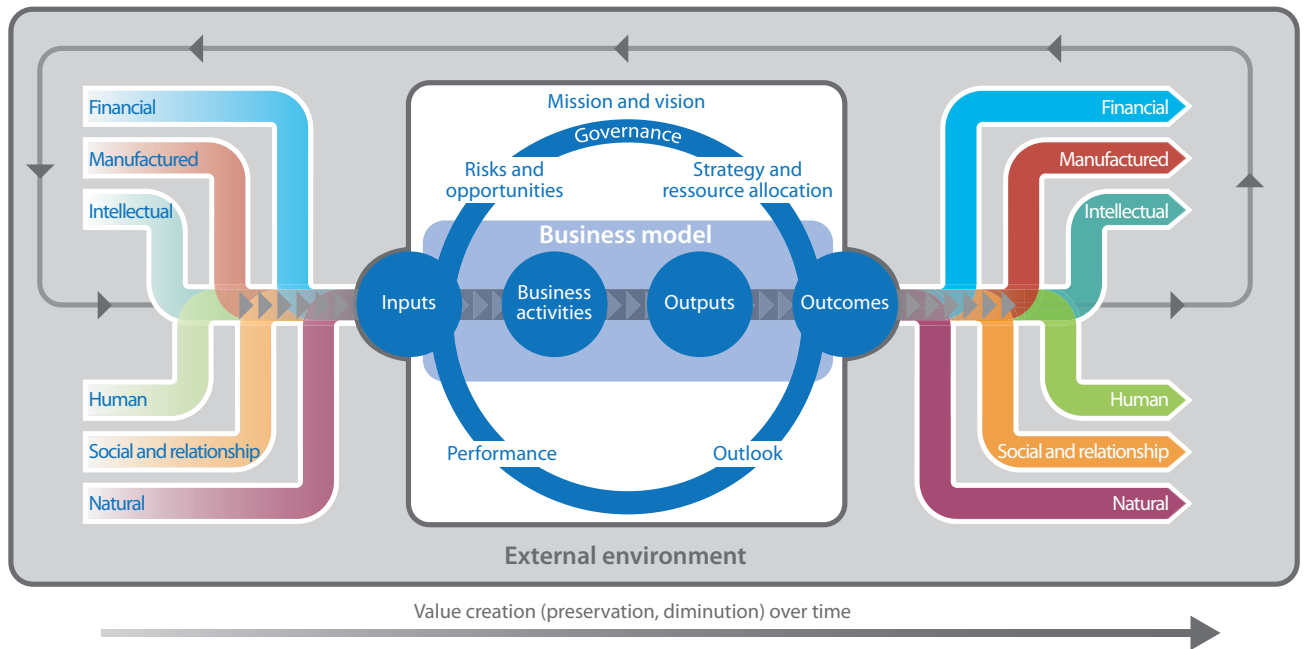
The value creation process and its associated capitals automatically fall within the scope of internal auditing as defined by the IIA: *“Internal auditing is an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance*

*An effective <IR> process should leverage the existing internal control and risk management systems. The scope of these systems is not limited to the reliability of financial reporting. For example: **The COSO Internal Control Integrated Framework (2013)** explicitly extended the scope of reporting objectives to non-financial information. Some principles of the COSO framework focus on specific resources such as human capital (principle 4) and IT (principle 11). The impacts of outsourced services on internal control effectiveness are discussed.*

Strategic objectives and opportunities are described in the COSO Enterprise Risk Management Framework (2004).



<IR> FUNDAMENTAL CONCEPTS AND PRINCIPLES



The value creation process. The IIRC (2013) , p13

processes”⁶. As such internal audit as an unrestricted scope not limited to financial capital.

An effective contribution of internal audit to the value creation process will depend on its authority and resources, through:

- The **right positioning** to be able to serve those charged with governance. *“To achieve the degree of independence necessary to effectively carry out the responsibilities of the internal audit activity. The chief audit executive has direct and unrestricted access to senior management and the board.”*⁷
- A **broad scope** with unrestricted access to the required information, consistent with the ambition of <IR>. And, where applicable, consideration of the organization’s stakeholders map and materiality analysis.
- **Adequate competencies** (whether in-house,

co-sourced or outsourced), to provide reasonable conclusions related to each category of capitals and their connected effects.

- An **internal audit plan** reflecting the **organization’s strategy** in the short, medium and long term. This could mean a paradigm change as internal auditors are traditionally risk focused but they are also able to develop an opportunity based approach.
- A **clear definition of internal audit’s role** with regards to the other lines of defense.

With their knowledge of the organization, internal auditors can take advantage of the broad scope of their engagements and their continuous interactions with the other lines of defense to help organizations accomplish <IR> activities.

⁶ Definition of internal auditing, The IIA (2013a).

⁷ IIA Standard 1100 Independence and objectivity.

<IR> guiding principles

The guiding principles underpin the preparation and presentation of an integrated report, informing the content of the report and how information is presented.

Point of focus of the task force	<IR> guiding principles recommended by the IIRC
Strategy and connectivity	<ul style="list-style-type: none"> • <u>Strategic focus and future orientation</u> • <u>Connectivity of information</u>
Significance and accessibility	<ul style="list-style-type: none"> • <u>Stakeholder relationships</u> • <u>Materiality</u> • <u>Conciseness</u>
Soundness and fairness	<ul style="list-style-type: none"> • <u>Reliability and completeness</u> • <u>Consistency and comparability</u>

The role of internal audit may relate to the IIRC principles in various capacities.

The principles of “strategic focus and future orientation” and “connectivity of information” relate to the strategic role of internal audit in support of those charged with governance and within the three lines of defense model.

The principles of “reliability and completeness” and “consistency and comparability” refer to more operational and traditional roles for internal auditors. Based on its maturity, internal audit is also able to contribute to the three other <IR> principles: “stakeholder relationship”, “materiality” and “conciseness”.

1. Strategy and connectivity

Through its close relationships with those charged with governance, engagements with different categories of functions and an in-depth knowledge of the organization, internal audit can contribute to the strategic alignment and connectivity of integrated reporting.

Strategic focus and future orientation

“An integrated report should provide insight into the organization’s strategy, and how it relates to the organization’s ability to create value in the short, medium and long term, and to its use of and effects on the capitals.”

To support future-focused activities and provide useful insights to those charged with governance, internal audit need to be strategically aligned through:

- an adequate reporting line to the highest level within the organization as well as a formalized internal audit strategic plan;
- the ability to encompass value creation as well as value destruction, which means a broader and proactive assessment of different kind of uncertainties;
- relevant and objective communication to those charged with governance⁸. For example, about the effect of the organization’s activities on the future availability and quality of the different capitals.

Internal auditors are able to contribute to the learning curve of their organization by challen-

⁸ About reportings to senior management and the board see standard 2060 (The IIA, 2013a).

ging the assumptions of some strategic developments or providing feedback on the lessons learned from past experiences.

Connectivity of information

“An integrated report should show a holistic picture of the combination, interrelatedness and dependencies between the factors that affect the organization’s ability to create value over time.”

Connectivity is an underlying principle of the three lines of defense model⁹: *“Without a cohesive, coordinated approach, limited risk and control resources may not be deployed effectively, and significant risks may not be identified or managed appropriately.”* Internal audit contributes to this comprehensive overview of the organization’s activities by providing independent assurance.

On this topic, internal audit can contribute by:

- having a broad and cross-functional scope, it is one of the best corporate functions for reviewing the reliability of different sources of information as well as the consistency of the content elements. For example, consistency between “external environment” and “risks and opportunities”; “value creation over time” and “outlook”; “balanced effects on various forms of capital” and “strategy”, “resource allocation” and “outlook”;
- making appropriate recommendations for *“coordinating the activities of and communicating information among the board, external and internal auditors, and management.”*¹⁰
- relying on other assurance providers, thereby limiting unnecessary duplication.

⁹ Position paper *The three lines of defense in effective risk management and control. The IIA (2013a).*

¹⁰ *Standard 2110 Governance IIA (2013a).*

To strengthen connectivity, internal auditors provide insights for the establishment of a sound reporting structure based on integrated thinking. As such, they contribute to mitigating compliance and reputation risk.

2. Significance and accessibility

Materiality is a classical element of audit methodology. However, it takes on another dimension when determining non-financial impacts. In an <IR> approach, significance of the organization’s activities is determined not only based on monetary thresholds but also includes an analysis of **stakeholders’ relationships**. The definition of materiality is key to meeting stakeholders’ needs and selecting important information as part of the **conciseness** objective of the report.

Examples of sources considered in the stakeholder engagement process:

- *customer satisfaction and customer complaints;*
- *climate surveys and internal communication;*
- *communication with analysts and investors;*
- *questionnaires from sustainability rating agencies;*
- *interaction with representative and category associations;*
- *institutional relations at national and local level;*
- *union relations;*
- *media monitoring and surveys.*

Mio and Fasan “The case of Enel” in Busco (2013)

Stakeholder relationships

“An integrated report should provide insight into the nature and quality of the organization’s relationships with its key stakeholders, including how and to what extent the organization understands, takes into account and responds to their legitimate needs and interests.”

Due to the diversity of capitals taken into account in an integrated report, there is an even more diverse category of stakeholders which can be providers of these capitals or be affected (in the short or long term) by the organization’s activities. The risks and opportunities underlying stakeholder relationships should then be managed at the relevant level within the organization.

The scope and competence of internal audit is sufficiently broad to encompass all kinds of stakeholder relationships¹¹.

To facilitate internal debates about the potential contradictions between different stakeholders’ needs and interests, the chief audit executive should:

- ensure that the internal audit activity has access to information about key stakeholders;
- encourage regular meetings with the main functions that deal with external stakeholders (investor relations, customer department, IT, etc.) as well as with the risk management and internal control functions in charge of following up risk mitigation action plans.
- sustain balanced internal communication on the representativeness of the stakeholder engagement process. For example, does it only focus on mainstream actors? Does it take into account future interests?
- review the inclusion of legitimate stakeholders’ needs in decision-making processes.

All these internal audit assurance and advisory activities contribute to the quality of the interaction with strategic partners.

Materiality

“An integrated report should disclose information about matters that substantively affect the organization’s ability to create value over the short, medium and long term.”

To manage their risks and opportunities, organizations are used to evaluating the significance of the impacts of uncertainties on its objectives. In the <IR> context, this analysis should continue to be based on the risk appetite and thresholds set by those charged with governance. However, it takes another dimension due to the diversity of information disclosed in the report and the objective of interconnectivity.

Major challenges of assurance providers are:

- *lack of detailed knowledge of the firm which is key for non-financial information*
- *lack of quantitative thresholds in order to assess materiality*
- *subjectivity in the materiality determination process*
- *traditional accounting reporting is backward-oriented while materiality content should be in accordance with the guiding principle of IR “strategic focus and future orientation”.*

Mio “Materiality and assurance: Building the link” in Busco (2013)

¹¹ For example, there are several relevant practice guides in the current IPPF (IIA, 2013a): *Auditing external business relationships; Evaluating corporate social responsibility; Global Technology Audit Guide on IT outsourcing, etc.*

Given their knowledge of the organization, internal auditors are well positioned to sustain the materiality determination process for <IR>. This input may be influenced by:

- the results of their engagements regarding the achievement of operational and reporting objectives;
- the conclusions of their review of the organization's risk management system;
- benchmarks regarding industry information and stakeholders' communication.

Through regular discussion with risk management functions and the conclusions of its own engagements, internal audit can effectively and efficiently evaluate the significance of various events, activities and decisions and assess if the organization has presented a balanced report of the material issues.

Conciseness

An integrated report should be concise.

One ambition of <IR> is to reduce the complexity and volume of information that is reported by organizations. The guiding principle of conciseness encourages organizations to focus on the material aspects of its value creation story, while eliminating redundancies and unnecessary detail. To anticipate resistance to change, internal audit can contribute to the conciseness objective in a number of ways, including:

- facilitate discussion between the reporting functions;
- evaluate compliance risks resulting from unbalanced reporting as regards conciseness on the one hand, and materiality or completeness on the other.

This principle is critical for effective reporting and ensuring value for key stakeholders.

3. Soundness and fairness

Organizations may face reputation risks or suffer from ineffective interaction with stakeholders due to the poor quality, comprehensiveness or accuracy of their disclosures.

In order to mitigate these risks, the <IR> Framework includes guiding principles that are focused on the soundness and fairness of the information presented in an integrated report.

Reliability and completeness

"An integrated report should include all material matters, both positive and negative, in a balanced way and without material error."

Reliability is the cornerstone of any accountability mechanism. Therefore data integrity and comprehensiveness are objective criteria of the organization's commitment to <IR>. The main challenge is the diversity of data providers and reporting mechanisms linked to the integrated report. The <IR> Framework states that reliability: ***"is enhanced by mechanisms such as robust internal control and reporting systems, stakeholder engagement, internal audit or similar functions, and independent, external assurance."***

It is not the responsibility of internal audit to determine what information must be disclosed or not. Disclosure structure and authority must be validated by those charged with governance. Nevertheless, internal audit can:

- provide an overall opinion on the internal control system related to the reporting objectives and the disclosure process;
- review the reliability of the continuous assessment performed by internal control and risk management functions to provide

an assurance that significant misstatements are detected and followed up;

- assess key reporting tools and automated control activities;
- challenge the reliability of the assumptions underlying future oriented information.

By enabling sound root cause analysis¹², internal audit can contribute to reducing errors and intentional misstatements.

Consistency and comparability

“The information in an integrated report should be presented: (a) on a basis that is consistent over time; and (b) in a way that enables comparison with other organizations own ability to create value over time.”

The data used for the integrated report are not necessarily based on shared rules or common practices within the organization and its stakeholders. While accounting standards can be used to mitigate data inconsistency over financial reporting, there are some major challenges around the consistency and comparability of non-financial information.

Internal audit can:

- provide assurance on the establishment of shared rules facilitating consistency and comparability;
- review risk control (including continuous monitoring) performed by second line of defense functions;
- benchmark against other organizations within and outside the industry, to highlight key inconsistencies.

Thanks to its knowledge of the organization and its familiarity with external and internal reporting standards, internal audit can facilitate the adoption of best practices aligned with the organization’s reporting strategy and promote integrated thinking.

¹² Practice Advisory 2320-2, Root Cause Analysis (IIA, 2013).

The content of an organization's integrated report will depend on the individual circumstances of the organization. However, the <IR> Framework recommends several content elements, stated in the form of questions rather than as checklists of specific disclosures, that are fundamentally linked to each other and not mutually exclusive.

The content elements recommended by the IIRC have been grouped by proximity with regards to governance risk and control issues:

Point of focus of the task force	<IR> content elements recommended by the IIRC
<u>Context and structures for value creation</u>	<ul style="list-style-type: none"> • <u>Organizational overview and external environment</u> • <u>Governance</u> • <u>Business model</u>
<u>Goals and outcomes monitoring</u>	<ul style="list-style-type: none"> • <u>Strategy and resource allocation</u> • <u>Performance</u>
<u>Dealing with the effects of uncertainty</u>	<ul style="list-style-type: none"> • <u>Risks and opportunities</u> • <u>Outlook</u>

After an overview of these issues, the task force suggested a number of actions for involving internal auditors in this area.

Context and structures for value creation

The organization's governance structure (such as roles, responsibilities, communication flows, cooperation between various functions, etc.) should be aimed at creating an integrated thinking process leading to reliable and efficient integrated reporting.

Internal audit is experienced and well positioned to review the effectiveness of such governance processes. Their knowledge of the organization helps facilitate potential changes in the governance structure in meeting the objectives of integrated reporting while taking into account the context.



INTERNAL AUDIT ROLES AROUND THE <IR> CONTENT ELEMENTS

1. Organizational overview and external environment

An integrated report should answer the following question:

What does the organization do and what are the circumstances under which it operates?

This element includes the organization's mission and vision and provides information regarding its operating structure, principal activities and markets, and competitive landscape. Additionally, disclosure of significant factors impacting the organization's external environment (i.e. legal, commercial, social, environmental and political context) should be included.

Internal audit efforts over this principle can take different forms:

- challenging the disclosure and its preparation process. This challenge could be based on:
 - conclusions over the organization's control environment,
 - reliance on other assurance providers,
 - reviews of the governance, risk management and control processes supporting the screening of the external environment, etc.;
- assessing the alignment of the organization's mechanisms around <IR> with its integrity and ethical values;
- challenging the capitals disclosed by the organization in relation with its business model;
- evaluating the adequacy of the organization's processes that define and monitor its responses to external events;
- providing insight on environmental threats and opportunities. This role will depend on

the maturity of the risk management system and on the knowledge present in the internal audit capabilities.

Recommendation: Audit value is expected through reviewing or challenging disclosures regarding the organization's values and providing assurance on the external environment screening processes.

2. Governance

An integrated report should answer the following question:

How does the organization's governance structure support its ability to create value in the short, medium and long term?

IIA standard 2110 states that: The internal audit activity must assess and make appropriate recommendations for improving the governance process (...)

A close relationship with senior management and the board is instrumental in fulfilling this role.

Internal audit efforts over this principle can take different forms:

- providing insight to governance bodies on <IR> principles and best practices;
- evaluating the effectiveness and efficiency of the steering, coordination and monitoring mechanisms (or functions) regarding <IR>;
- assessing clarity of ownership, including a review of potential inconsistencies within the organization structure or the stakeholder engagement process;
- reviewing commitment to transparency and accountability;

- reviewing the design and effectiveness of the change in <IR> program, where applicable;
- contributing to the improvement of integrated thinking. For example by:
 - focusing on connectivity issues and soft controls,
 - reviewing data integrity,
 - assessing whether integrated thinking is embedded in the organization (clear rules, tone at the top, open discussion around integrated reporting/thinking issues, etc.),
 - reviewing proper cooperation between business lines and expertise functions (such as risk management, internal control, legal, finance, IT, HR, investor relations, sustainability, quality management, customer satisfaction, safety and environment, etc.).

Recommendation: Internal audit should review the governance around <IR>, including integrated thinking and the contribution to value creation, with a focus on soft controls.

3. Business model

An integrated report should answer the following question:

What is the organization's business model?

The IIRC presents business models as the core of the organization's value creation process.

Recommendation: Internal audit should review the accuracy of the organization's business model as described in the report.

Internal audit efforts over this principle can take different forms:

- evaluating the alignment of the business

model description with the organization's disclosure strategy;

- reviewing the efficient use of the different capitals and their effects on the business model;
- informing those charged with governance on gaps due to the diversity of business models within the organization;
- evaluating how the organization monitors internal and external changes and their potential impacts on the business model.

To maintain an effective internal control, organizations should identify and analyze significant change especially the changes in their business model: "The organization considers the potential impacts of new business lines, dramatically altered compositions of existing business lines, acquired or divested business operations on the system of internal control, rapid growth, changing reliance on foreign geographies, and new technologies".

COSO (2013) Principle 9

Goals and outcomes monitoring

These content elements ("strategy and resource allocation" and "performance") are particularly linked to the <IR> principles of "strategic focus and future orientation" and "reliability and completeness". They should be consistently treated in internal and external reporting to illustrate how the business model contributes to value creation over time.

Tone at the top is key: "Management, with board oversight, sets entity-level objectives that align with the entity's mission, vision, and strategies. These high-level objectives reflect choices made by management and board of directors about how the organization seeks to create, preserve, and realize value for its stakeholders".

COSO (2013)

1. Strategy and resource allocation

An integrated report should answer the following question:

Where does the company want to go and how does it intend to get there?

Organizations achieve the strategic and business objectives set by those charged with governance through strategic plans, supported by resource allocation and action plans, which highlight the organization's business model and how it creates value over time. These plans should be sustained by effective risk responses and maximized opportunities.

Recommendation: Internal audit can contribute to the improvement of the strategic planning process and assess its alignment with the organization's mission and resource allocation.

Internal audit efforts over this principle can take different forms:

- reviewing the strategic planning process in order to:
 - assess conformance with the organization's mandate, the mission and values set by those charged with governance,

- challenge the methodology (forward looking, open to outside views, logic and reality of the assumptions, robust checks and balances, etc.),
 - evaluate the supporting functions;
- providing assurance on the level of justification and validation of any significant strategic change;
- evaluating the alignment of the strategic alternatives with the organization's risk appetite;
- evaluating if business objectives closely reflect the strategic plan;
- providing insights, based on root cause analysis of the gaps identified, including differences between planned and actual budget;
- reviewing the alignment of resource allocation with strategic objectives and the existence or availability of key capitals;
- discussing, with those charged with governance, opportunities for improving board oversight of strategic planning;
- holding discussions with the chairman of the board committee in charge of internal audit activities (generally the audit committee) to ensure connectivity with other relevant board committees.

2. Performance

An integrated report should answer the following question:

To what extent has the organization achieved its strategic objectives for the period and what are its outcomes in terms of effects on the capitals?

Organizations have different performance measurement and monitoring mechanisms. Internal control systems help ensure sufficient oversight and information flows. The <IR> principle of connectivity is particularly important in this content element.

The internal audit activity must assess and make appropriate recommendations for improving the governance process in its accomplishment of the following objectives; [...] ensuring effective organizational performance management and accountability...

Standard 2110 (The IIA, 2013a)

Recommendation: In evaluating the governance and internal control processes related to performance, internal audit contributes to the quality of the information used for decision-making or disclosed in the integrated report.

Internal audit efforts over this principle can take different forms:

- evaluating if the <IR> report reflects internal indicators about the achievement of objectives;

Good practices for the review of <IR> KPIs :

- *Do they cover each dimension of the value creation (competitors and best practices, the entire value chain, etc.)?*
- *Do they reflect economic, environmental, and social issues?*
- *Is their determination formalized? (purpose, reason why it is "key", calculation method, source of data or assumptions, etc.)*
- *Are the KPIs comparable over time and between organizations?*
- *Are they monitored? Are the reasons for success and failure discussed?*
- *Are they sufficiently forward-looking?*

Bartolini, Santini, and Silvi : "Performance Measurement and Capitals" in Busco (2013)

- evaluating the reporting strategy of the organization and the adequate communication of the KPIs to the disclosure functions;
- reviewing the design and selection of key (quantitative and qualitative) performance indicators:
 - do they reflect stakeholders' legitimate interests?
 - are they sufficiently clear?
 - are they compliant with legal requirements and the organization's integrity values or transparency commitment?
 - are they updated specifically in order to improve the organization's disclosure on its value creation process?
 - do they target current and emerging key stakeholders?
- reviewing internal control related to the preparation and processing of data, in order to:
 - challenge assumptions and methods underlying the collection, verification and processing of input data,
 - review underlying IT tools¹³,
 - address connectivity challenges,
 - perform root cause analysis of significant gaps between planned and actual KPIs,
 - give an opinion on the degree to which indicators are accurate and free from errors or voluntary misstatements;
- coordinating with the second line of defense in charge of the continuous monitoring of the KPIs;
- providing benchmarks, information and training.

¹³ Standard 2110.A2, IT Governance (The IIA, 2013a).

Dealing with the effects of uncertainty

Assessing risks and opportunities is part of any risk management process which aims to manage their potential impacts on the achievement of objectives. The outlook section may be challenging to disclose as it is linked to sensitive subjects such as the organization's strategy and future performance.

1. Risks and opportunities

An integrated report should answer the following question:

What are the specific risks and opportunities that affect the organization's ability to create value over the short, medium and long term, and how is the organization dealing with them?

As defined by risk management frameworks, the identification of risks and opportunities should cover their potential effects on all of the organization's categories of objectives (strategic, operational, compliance, financial and non-financial reporting).

Recommendation: Internal audit can assess if the integrated report includes key information about the risk management process.

Internal audit efforts over this principle can take different forms:

- as part of its annual audit plan, internal audit contributes to monitoring and analyzing potential external environment impacts;

¹⁴ See IPPF Practice Guide, *Assessing the adequacy of risk management* (The IIA, 2013a).

¹⁵ Position paper, *The three lines of defense in effective risk management and control* (The IIA, 2013a).

Organizations are increasingly deploying risk management functions as part of their second line of defense.

According to the IIA Position paper: The three lines of defense in effective risk management and control, "the risk management function typically facilitates and monitors the implementation of effective risk management practices by operational management and assists risk owners in defining the target risk exposure and reporting adequate risk-related information throughout the organization." One of the outputs of the risk management function is the risk map, which may be used in the preparation of Corporate governance reports, especially for listed companies.

"Internal auditors provide the governing body and senior management with comprehensive assurance based on the highest level of independence and objectivity within the organization."

- regularly reviewing the adequacy of the risk management system¹⁴;
- providing "assurance on the effectiveness of governance, risk management, and internal controls, including the manner in which the first and second lines of defense achieve risk management and control objectives"¹⁵;
- reviewing consistency, integrity and reliability of disclosures regarding risks and opportunities;
- ascertaining the scope of the risk management process. Does it cover all the relevant capitals and stakeholders? Does it give a sufficient overview of short, medium and long term effects? Does it consider opportunities?

The efficiency of risk management processes depends on different factors such as the over-

sight of those charged with governance and the level of assurance provided to them. In the second line of defense, several functions (internal control, risk management, IT security, corporate social responsibility, etc.) contribute to this assurance. Mapping risks with assurance functional responsibilities illustrates the coordination efforts.

Recommendation: The disclosure of an “Assurance Map” in the integrated report is valuable to those charged with governance and key stakeholders. Internal audit can contribute to the reliability of this information.

Internal audit efforts over this principle can take different forms:

- as the independent line of defense, challenging assessments from other functions;
- facilitating the establishment of an assurance map for significant risks.

Recommendation: <IR> effectiveness is linked to the quality of key risk criteria and indicators. Internal audit can contribute to improving the design and monitoring of these elements.

Internal audit efforts over this principle can take different forms:

- reviewing the process for the establishment of key risk indicators and their communication across the organization;
- evaluating the inclusion of these indicators in the integrated thinking and the integrated report;
- assessing the consistency of these indicators with the organization’s materiality thresholds;
- periodically monitoring the responses (or reviewing assessments carried out by the second line of defense or by management) to threshold overruns;

- reviewing with the risk management function the appropriate consideration of a forward looking approach.

2. Outlook

An integrated report should answer the following question:

What challenges and uncertainties is the organization likely to encounter in pursuing its strategy and what are the potential implications for its business model or future performance?

This question explicitly makes a link with other content elements of an integrated report (risks and opportunities regarding uncertainties, business model, strategy and performance). Based on the connectivity principle, it could also be related to other elements such as the organization’s overview and governance or external environment.

COSO 2013 states that “Risk is the probability that a fact will take place affecting in a negative manner to the objectives of the organization.” Accordingly, the potential challenges or uncertainties the organization is likely to encounter in the future are identified in the organization’s assessment of its strategic, operational, compliance or reporting risks.

Recommendation: An integrated report discloses information based on knowledge of the main challenges of the organization’s strategy and the action plans to deal with them. Internal audit activities should be leveraged for reliable disclosures.

Internal audit efforts over this principle can take different forms:

- reviewing the connectivity between external factors monitored by the organization (e.g., as part of its risk mapping) and social, legal, economic or environmental uncertainties disclosed in the outlook element;
- coordinating regularly with – and reviewing – the risk management function;
- assessing the accuracy of the strategic plan on which the outlook is based;
- providing insight on the internal and external dynamics of the organization's value creation process.

1. Task force objectives and approach

The task force is a joint initiative of IIA France (IFACI) and IIA Spain (IAI) in collaboration with several European institutes affiliated to the IIA (Institute of Internal Auditors) such as IIA UK & Ireland, IIA Netherlands and IIA Norway.

Due to the early stage of development of <IR>, the task force believes that there is a need to clarify the role of internal audit by establishing a clear understanding of <IR> challenges and benefits. The task force also set out to present the potential impacts on the interactions with those charged with governance and other assurance providers.

Objectives:

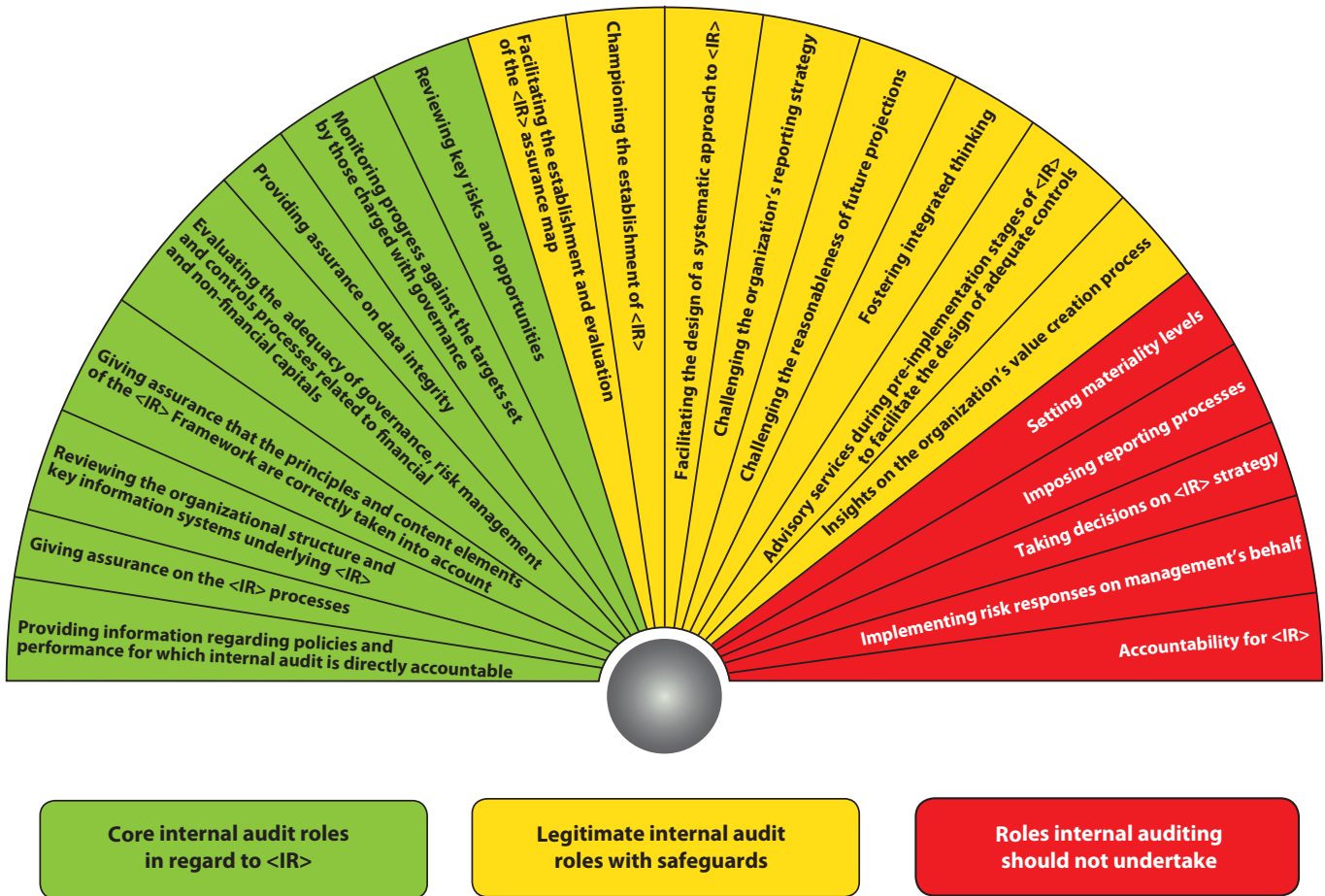
- Identify governance, risk management and control issues regarding integrated reporting.
- Provide trends and best practices that help organizations leverage their internal control and risk management systems to better use financial and non-financial resources.
- Clarify internal auditors' advisory and assurance roles during the implementation and post-implementation phases of integrated reporting processes (for example in relation to data integrity, adequacy of structures and controls, the elements highlighted by the IIRC, etc.).
- Establish the specific responsibilities of internal audit and its interaction with other lines of defense within and outside the organization.
- Recommend practical approaches and key success factors.

Approach:

- Understanding <IR> concepts through a literature review and discussion with the CEO of the IIRC (Paul Druckman) in Madrid in April 2014.
- Collating feedback on members' reporting strategies and the role of the internal audit function as well as the risk management and internal control functions.
- Discussions around each content element and principle of the Framework for linkage with existing practices and emerging roles.



2. The <IR> fan: several roles for internal audit



This diagram is adapted from "Position Statement: The Role of Internal Auditing in Enterprise-wide Risk Management," reproduced with the permission of IIA UK & Ireland. For the full statement, visit www.iaa.org.uk. © The Institute of Internal Auditors – UK and Ireland Ltd., July 2004.

3. Examples of <IR> initiatives and internal audit roles

CSR reporting and <IR> in my organization

Solvay also has a strong <IR> culture due to its type of industry (chemical products) and customers. The SolvayWay approach (which takes into account the stakeholder engagement process) is implemented throughout the Group, supported by a decentralized network of champions from each key corporate function. It is self-assessed and regularly evaluated by internal audit. CSR reporting follows the GRI Guidelines. A task force was set up last year to take the IIRC principles more closely into account. Each corporate function (such as internal audit and risk management) is represented in this group. The CSR department is in charge of the task force. The upcoming reporting will be based on the KPIs selected together (the idea is to reduce the number of KPIs, be materiality-focused and oriented towards long term aspects).

Sustainability KPIs are taken into account for the development of new products and the portfolio analysis.

At **Danone**, Antoine Riboud, one of the co-founders and former CEO of Danone, was a strong advocate for the so-called "double project". In his words, "the responsibility of a company does not end at the plant's gate" because a company cannot grow and develop itself in isolation from its ecosystem. Therefore, we can say that the integration of business and sustainability issues is in the DNA of Danone.

The CEO of Danone, Franck Riboud, Antoine's son, has always maintained this conviction in his various speeches and actions. Therefore, it was only natural for Danone to accept the IIRC's invitation to join the Integrated Reporting pilot program. To lead this project, an internal finance professional with CSR experience was designated. So far, the outputs of the project have not been communicated externally. Internally, many meetings have been and are being held concerning the project, gathering different key functions, including internal audit.

In a benchmark performed by IIA Spain on the IBEX-35 index, internal audit roles in external reporting are centered on:

- awareness of the audit committee;
- compliance of ethics related engagements;
- evaluation of risk management systems;
- review of the content element of the report;
- review of internal control in relation to the reporting process;
- due diligence audit.

An non-exhaustive list of risks

Business risks

Company reputation/brand value

- Business continuity
- License to operate

Physical risks

Air pollution limits

- Changes in frequency of extreme weather events
- Changes in natural resource availability
- Changes in supply chain and/or customers

Regulatory risks

- Uncertainty surrounding new regulations including changes in air quality or emissions standards
- Potential for litigation
- International agreements
- Carbon taxes and cap and trade schemes
- Changes in water pricing schemes
- Emission reporting obligations

Nefedova (2014)

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