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CFO Dialogue 2014

THE CUTTING EDGE CFO

The Epitome of Integrated Reporting

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INTRODUCTION: THE EPITOME OF INTEGRATED REPORTING

At the heart of CIMA's evolving 95-year-old foundation of expertise is a wide body of quality research collated from, and shared with, a global network of business leaders and influencers.

CIMA is fortunate to count as its partner its advisory panel in the United Kingdom, comprising a group of directors of many of the top 100 companies in the UK, a panel with whom CIMA meets twice a year.

Additionally, CIMA has conducted a series of roundtables in several markets where varied business leaders from multiple sectors and industries have shared their invaluable experiences and perspectives on issues from employment to environmental changes impacting business, resulting in a large contribution to CIMA's existing library of research.

As CIMA is a body that looks at all issues surrounding management accountants, it is only natural for the evolving role of the CFO to be spotlighted. The role of the CFO is a pivotal one in driving the long-term success of business and organisations in public and private sectors. In many cases, the CFO often steps into the shoes of the CEO, underlining the importance of the CFO's role.

Looking at the wider picture, the way going forward for business and society is as complex and diverse as the relationship between the two.

The recent inaugural CFO Dialogue: The Cutting Edge CFO conference in Kuala Lumpur saw business leaders introducing the conversation about the need for integrated thinking and the framework and business tool that is Integrated Reporting, in addition to other related topics, such as employment, the six capitals and board expectations.

This special report – an amalgamation of views and thoughts from many business leaders, high-profile influencers and powerful, leading organisations across sectors, markets and geo-borders - shares key insights into the changing world of business, business models, the external environment, integrated thinking and integrated reporting.

This report is produced following the conclusion of a highly-engaging and successful business dialogue aptly named the CFO Dialogue: The Cutting Edge CFO, organised by CIMA in collaboration with the MIA, held in September 2014 in Kuala Lumpur. It also includes key points from previous periodicals of research published by CIMA.

Keynote speakers included Charles Tilley, the Chief Executive of CIMA, who spoke at length about various issues surrounding the world of business. The dialogue participants were fortunate to have had the privilege of the presence of former South African Supreme Court judge and Chairman Emeritus of the Global Reporting Initiative, the illustrious and deep-thinking Professor Mervyn E. King, who currently serves as the Chairman of the International Integrated Reporting Council (IIRC).

Lending their views, thoughts and perspectives to the meaningful day-long dialogue were international and regional CFOs, directors and business heads who brought with them a wealth of experiences that lent a rich dimension to the day's robust conversations via several panel discussions and Q&A sessions.

BUSINESS MODELS AND ORCHESTRATED CHAOS

At the heart of any business is an idea. When that idea meets desire, the will to create value is born.

The creation of value is the lifeblood of business. Without value creation, the raison d'être for a business evaporates. When business managers at the highest levels understand this, there is growth, innovation and sustainability.

However, there are external factors at play to consider.

"Today's commercial environment is characterised by rapid change," states the report Building Resilience (published by CIMA and AICPA.)

The changes, occurring at an unprecedented rapid pace, are:

- The introduction of new technologies
- The shift in consumer / customer desires and behaviour
- When supply and distribution chains mutate
- The rise and fall of the influence of stakeholder groups

This is by no means an exhaustive list. The landscape of change also includes factors such as the need for (or dearth of) unique or employable skills (a business needs the right people with the right skills as supportive pillars), employment trends, population and generational changes as well as geo-political changes.

All these factors impact business, highlighting once again how business does not operate in a vacuum.

When business managers understand the volatile nature of these factors within the context of value creation set against the backdrop of a business model, they understand the fluid and sometimes fickle nature of business, and the need for sustainable business models and sustainable value creation.

The external environment in which any business operates is changing faster than that at which deliverables or success can be measured.

The arrival of integrated thinking and integrated reporting is all but inevitable. The success of business tomorrow depends on integrated thinking.

Business as it has been known since the Industrial Revolution, no longer exists as an ivory tower of isolation.

ORCHESTRATED CHAOS

The term 'orchestrated chaos' was one aptly coined by a member of CIMA's UK-based advisory panel; the term describes the external environment we are living in today.

Additionally, 300 key executives from around the world volunteered their views to CIMA in 2012 and spoke about what they saw as the key issues facing business today.

In this increasingly globalised economy that is rapidly becoming borderless, the impact of the digital world and its attendant digital economy cannot be ignored nor dismissed.

Evidently, technology has impacted structural changes in brick-and-mortar businesses – some positive, others requiring a period of adjustment.

However, there is also the recognition that technology can be as disruptive a force as traditional risks and challenges that have come to be expected in a textbook business cycle.

THE IMPACT OF TECHNOLOGY: TURBULENT TIMES?

It is a staggering realisation when the facts are compared: there are 7 billion people on the planet, but there are 12 billion interconnected mobile devices.

Add to this the presence of internet-based cloud computing, mobile computing, 3D printing, big data, advanced analytics, next-generation genomics and advanced robotics, and technology has become more than a buzzword or a trend: it is the new reality.

McKinsey & Co reported not just the identification of 12 key technologies that will impact the world of business, but also that we would see, by 2025, some USD14 to 33 trillion in terms of potential value creation.

One need only look at the innovation in the areas of digitised books, audio-visual technologies, digital communications technology, drone delivery systems, payment technology on mobile devices or even the mushrooming of online media portals to see the limited life cycles of products and services that were once thought to be recession-proof.

Big data, too, affects business. It is conspicuous and it wields influence in decision-making.

Corporate leaders now grapple with big data and the need to deduce sharp insight from it.

"The ability to deal with data," says CIMA chief executive Charles Tilley, "has never been more important, in order to deal with competitive assessment."

BIG DATA, BIG DECISIONS

Big data can be generated from physical assets such as machinery downtime, which will have an impact on efficiency, but big data also offers opportunities for customisation. In this respect, the ability to deal with data can open new doors to new forms of business models – such as peer-to-peer business - and more importantly, new ways of creating value, for example, the monetisation of data.

Data can also come from new, external and unexpected sources, such as social technology.

This is the juncture at which technology, big data and business decisions, collide.

The impact of social technology is felt on several fronts – consumer, social and personal - but its far-reaching effects are just as keenly felt when

this technology allows stakeholders to connect, outside the control of an organisation, on multiple platforms.

Organisations and companies must now be able to solve their problems by using their customers, engaging their customers and getting actual feedback as to what they (the customers) want, and what their experiences are.

The primacy of the customer is considerable and becoming more so as technologies mushroom and your competitors have learnt how to copycat and carry out your business with less financial, social and environmental cost.

Non-financial customer, social and individual feedback on social media platforms can have both positive and negative financial impacts on any business, large or small.

Research work done, entitled “Roads to Ruin – A Study of Major Risk Events”, by an insurance company and produced by AIRMIC, the Association of Insurance and Risk Managers in Industry and Commerce, looked at 17 huge disasters where some companies handled it well and some handled it badly, including Enron, Arthur Andersen, Northern Rock, Societe Generale, BP and Shell.

With the onslaught of seismic change, the question remains, how does – and how can – one remain relevant, stay informed and keep up-to-date in this orchestrated chaos?

And more to the point, how does all this impact the role of the CFO?

THE ROLE OF THE CFO: JUGGLING CASH, HATS & RELATIONSHIPS

In brief, the role of the CFO involves four key tasks:

- Ensure the organisation does not run out of cash (financial security)
- Understand the environment and key drivers (strategic direction)
- Build capability and ensure competency for the future
- Ensure compliance and controls remain fit for this purpose

Additionally, the CFO wears several hats and juggles several key relationships.

A CFO is not only a member of the management team who supports the CEO in driving the organisational agenda, but he/she also provides critical checks and balances to the CEO's objectives, plans and strategic execution. Just as importantly, the CFO also serves as an executive director who provides a second view on performance to members of the board. Internally, the CFO serves as the head of human resources (e.g., recruitment, talent development) for finance functions.

The hurdles and challenges are far less simple.

Governance used to be clear-cut, but governance must now include the greater scope of public interests. Resources were once thought to be limitless, but the reality is very different. Financial security is no longer about a simple set of figures presented on a balance sheet.

Thirty years ago, 80% of a company's value and market capitalisation would be represented on its balance sheet; today, that figure is at 20% and is decreasing.

That in itself is one of the reasons for the importance of Integrated Reporting to be able to tell a story way beyond the value of the balance sheet of a company and the impact of your organisation on your customers and on society.

Equally important is the subject of skills. It is no longer sufficient for finance professionals to simply be better at numbers and financial gatekeeping than others: finance professionals now need to be great communicators and dynamic leaders, team-builders and influencers, too. (Sometimes all at once in the space of a business day.)

There is the view that if we were to look at business failures around the world, some have very much to do with the failure to grasp what is happening outside the company in the global village, and the failure to address those changes. And so it becomes more important for the CFO to manage and communicate effectively what the data means.

Furthermore, to add to an increasingly complex portfolio, the CFO must now understand, absorb and apply the new tide in - and stakeholder-driven demands for - better financial reporting.

No amount of information is useful if it is not communicated effectively or properly. The ability to get your story out well is important; and so, from the position of the reader - the stakeholder - as to putting forward your view, people and leadership skills are absolutely important.

The survival of the CFO as a species looks to be fairly dependent on its ability to adapt to its fast-changing external environment.

THE EVOLUTION OF CORPORATE AND FINANCIAL REPORTING

To understand the contemporary and cogent need for Integrated Thinking and Integrated Reporting, we need to understand the historical and societal origins of corporate and financial reporting.

"The cost of bad decisions can be very significant."

THE HISTORY OF FINANCIAL REPORTING

If you think about the 19th century, there were about a billion people on planet earth and there were no CFOs. The concept of limited liability was firmly entrenched by the 1860s.

But it was wealthy families who were the providers of capital and family members of those wealthy families were also the directors of those companies.

And it was almost a natural consequence that other stakeholders, particularly the employees, saw the shareholders as the owners of the company.

Many of today's business managers were educated, nurtured and brought up on the basis that the shareholder is the owner of the company and that shareholder primacy held court over all else.

The company is a person; it is incapacitated and inanimate until you are appointed its director. You become the heart, mind and soul of this incapacitated person. That gives content to the well-known duties of the director of good faith, carrying out the purposes of the business, caretaking, taking care of the assets, taking care in your decision-making.

In that context, directors continue to steer companies (from the Latin origin, directus, which means 'to steer' or 'set straight') and through the great depression in the 1930s there is no mandatory provision to do financial reporting.

That is why, with some confidence, Professor King had stated that there is no such thing as a CFO in the 19th century and the early part of the 20th century.

However, the CFO became critical once financial reporting became mandatory.

And so historically the International Accounting Standards Board and the IFRS (International Financial Reporting Standards) were developed.

Directors then steered the companies into the 20th century. Companies almost never used to do financial reporting until the mid-20th century or at the earliest, soon after the 1930s.

Yet, from that point, there was no universal standard of financial reporting. Towards the end of the 20th century, this continued unabated.

According to Professor King, who has served on the boards of companies listed in London, Europe and South Africa, there are annual reports that are 400 pages long and plainly incomprehensible.

> **“When reports are incomprehensible, we are not being accountable. We are failing in our duties as directors, to report.”**

Consensus came towards the end of the 20th century. The International Federation of Accountants (IFAC) is reported to have declared that financial reporting, though critical on its own, was not complete.

1997 saw thought leaders saying we need standards on these intangible assets – some call them invisible assets.

HOW THINGS HAVE CHANGED

Human capital and natural capital are inextricably connected to financial and manufactured capital.

The reporting traditions of the 20th century failed to show the interconnectedness of the six capitals as highlighted by Professor King. Financial reporting did not adhere to a universal nor international standard until after the 1930s. The picture, as told by financial reporting, was incomplete.

Integrated reporting tells as full a picture as possible about a company.

This is underlined by the external environment and the sweeping changes in it.

From technology to customer expectations and greater information flow, the environment in which a company operates is changing at a pace that exceeds an organisation’s ability to refine its strategy and the delivery thereof.

Examples such as Enron, Nike and Starbucks are oft quoted.

Though corporate disasters and missteps are well-documented, the foresight before and the hindsight after these cataclysmic events are key lessons for the business community.

One of those key lessons is that sometimes the non-financial assets or intangible assets – some say invisible assets – can destroy a company financially.

For example, if your supply chain was discovered, as in Nike’s case, to expose the fact that your shoes are made by using child labour, the next morning, on the stock exchange you could lose 60% market share.

Research has since identified that there are the six capitals or resources: human, natural, intellectual, financial, manufactured and social (relationships).

> **“It is this social capital that shows that relationships are absolutely critical.”**

It is through social capital that we begin to see and understand what integrated thinking really is about.

THE SIX CAPITALS

The 19th century company directors thought they had unlimited natural assets even though we now know that natural assets are finite and decreasing in supply.

"We are using natural assets faster than they can be generated."

The definition of the six capitals is as follows:

Financial Capital:
The pool of funds available to an organisation for use in the production of goods or the provision of services

Manufactured Capital:
Manufactured physical objects (as distinct from natural physical objects) that are available to an organisation for use in the production of goods or the provision of services

Human Capital:
People's competencies, capabilities and experience, and their motivations to innovate

Intellectual Capital:
Organisational, knowledge-based intangibles

Natural Capital:
Renewable and non-renewable environmental stocks that provide goods and services, supporting the current and future prosperity of an organisation

Social (relationship) Capital:
The institutions and relationships established within and between each community, group of stakeholders and other networks, including an ability to share information, to enhance individual and collective well-being

Of the six capitals, there is human capital and its supply and demand, and natural assets and creating things that company directors said belong to them, and the products and services that were sold to consumers, which developed into and is termed manufactured capital.

And of course there is financial capital. What is extraordinary to integrated thinkers now is the observation that directors in the 20th century thought it was sufficient to report only on the financial and manufactured capital **AS IF WE HAVE STOPPED MAKING USE OF THE OTHER CAPITALS.**

As if the other capitals were not in any way connected to the financial and manufactured capital, as Professor King reiterates emphatically, when, in fact, nothing could be further from the truth.

There are six resources used by companies - perhaps some of which organisations are unaware they are using them - but the fact remains that organisations use these capitals.

Companies use them because they belong to society. Financial, manufactured, human, intellectual, natural – the air we breathe - and social capital, which focuses on relationships: the relationships between stakeholders themselves, between stakeholders and the organisation and so forth.

Social capital is the organisation's social licence to operate.

Relationships denote interconnectedness, and interconnectedness lies at the heart of integrated thinking.

INTEGRATED THINKING: THE NEW BUSINESS SUCCESS?

Integrated thinking is, at its heart, about INTERCONNECTEDNESS and approaching the management of value creation in an inclusive manner that reflects the interconnected relationships between capitals, inputs, outputs, outcomes and impacts.

Social capital, which is all about relationships which are absolutely critical, forms a key part of what INTEGRATED THINKING is about.

It is about this integration and showing the interconnectedness and inter-relationship between the resources used by the company and the on-going relationship between the company and its various stakeholder groupings.

We, as the people who populate, direct and consume from organisations, start with society and end with society.

But in between, the organisation uses these resources with this ongoing relationship with the stakeholders and, NOT JUST the shareholders.

Organisations need to understand how the capitals interact with each other to create (or potentially destroy) value. Failure to consider the material impact our business activities have on all capitals carries the potential for disaster.

THE INCLUSIVE APPROACH: INTEGRATED REPORTING

As standards became known through the Global Reporting Initiative, it became standard to report on the so-called NON-FINANCIAL aspects of an organisation.

"The Integrated Reporting framework uses the concept of "capitals" to illustrate the resources and capabilities an organisation may require and utilise to create value."

Within the Integrated Reporting framework, there is a clear distinction between outputs and outcomes.

Outputs are key products or services produced by an organisation to create value as well as the waste or other by-products that may either create or erode value.

Outcomes, on the other hand, are the internal and external consequences for the capitals as a result of an organisation's business activities and outputs, including customer satisfaction, profit (or loss), shareholder return and contribution to the local economy through taxes.

In the case of a car manufacturer, the output is the car, while the outcomes to the consumer may be mobility, safety, reliability, comfort and status. Outcomes that flow beyond the customer include environmental impacts arising from emissions.

Professor King illustrates this point with a relatable story.

Everyone in the world knows of the Coca Cola can or bottle. They created the most important brand. But when Coke was found (by certain segments of society in the US and Mexico) to be responsible for child obesity, there was the question of whether Coke should be taxed. The board found the product was having an outcome, an IMPACT, on the very resources that they had been putting in for a hundred years. There was an impact on society.

This is an OUTCOME, where the OUTPUT was having an impact on a capital – human and social.

And so started in May 2013 their new marketing campaign where they not only did not advertise to children under the age of 12 but also encouraged exercise at all their bottling plants around the world for children; and they decreed they would have nutritional labelling on all their cans and bottles.

Thinking from the input is part of integrated thinking. Integrated thinking – thinking from the input – HOW the company makes its money. When Coke decided to put nutritional labelling on its bottles and cans, this was part of integrated thinking.

"I've read the annual report but I don't understand how it has made its money."

Milton Friedman, in the late 1970s said, the sole purpose of the corporation is to make profit without deception or fraud; if there is the suggestion that a company is not part of society, or that companies stand apart from society: this is clearly not the case, anymore.

But the question is: do stakeholders appreciate the fact that companies are a critical part of society and vice-versa?

Perhaps the best proof of this lack of reflective big-picture appreciation is the collapse of Lehman Brothers, which affected millions. The collapse of Microsoft today would have an equally wide-ripple effect.

How does any company make its money and how do its outputs have an impact financially, environmentally and socially? These are the three most important elements and critical aspects.

And, value. How do the accountants in the room talk about value? They were most likely taught that value is the present value of discounted future cash flow. They look exclusively through a financial lens and they may not be concerned with how the cash flow was created.

That has all now changed.

Value today is seen as what are the impacts of how the company makes its money – financially, socially and environmentally?

What are the positive impacts and how is the company harnessing and enhancing these positive impacts? What are the negative impacts? And how is the company, in its long term strategic thinking, going to eradicate or ameliorate the negative impacts?

Regular reassessment of desired outcomes against actual performance, outputs and strategic objectives may prompt adjustments and changes to the business model.

In this uncertain world, management accountants have a key role to play in ensuring their organisation's business model remains relevant, resilient and responsive.

A board should have on its agenda at each board meeting the subject of stakeholder relationships, something some organisations have never had at board meetings. But today great companies do have this on their agenda. Some of the world's great companies, in dealing with stakeholder relationships, have appointed a whole new corporate animal to handle stakeholder relationship, the Stakeholder Relationship Officer, a very senior executive, whose sole job is to understand the business, understand who the key stakeholders are and have an ongoing communication with them and learn of their needs, interests and expectations, let them know what the company expects of them, because it's a two-way street, and inform management. Like a written report to the board for each board meeting.

The board is thusly informed of these relationships. The board is agreeing and entering into an integrated report, being aware of the resources used and the relationships with stakeholders.

An informed management body, on the basis of this, can develop strategy. The board is making an informed decision and has adopted integrated thinking without realising it, by integrating stakeholders into their decisions.

Integrated reports break down the silos of individual divisional reports that may broadcast separate, or worse, contradicting messages that spotlight the cracks in an organisation and send conflicting messages to its stakeholders. This becomes more than an act of misinformation – in itself a liability – it reflects an inclination to not be held accountable for how an organisation makes it money while having an impact on society.

To be accountable, an organisation and its integrated reports need to be understandable. And in order for there to be effective communication to stakeholders, the board and the organisation it steers have to have effective communication between all its parts.

The organisation needs to move, think and speak as a collective body in order to be allowed to operate within society for the collective good.

PERSPECTIVES ON INTEGRATED REPORTING

There is a need for coherence and consistency to be present in both your messages and in your reporting – in a local context, this is a valid concern.

When you consider that there is the wider net that is social media – in addition to traditional channels of information distribution, dissemination and broadcast – you have to make sure your messages are consistent, that you are all, internally and externally, singing the same tune. You do not want your non-financial report to make reference to an aspect of operations that your financial report will contradict.

One of the concerns surrounding integrated reporting is the challenge of aligning the internal and external messages and information. In a traditional corporate set-up, we often find the accountants who control the accounts, another set of people producing the HR report and yet another handling the sustainability report while Marketing or PR might be allowed to handle the annual report on occasion.

And then there is the concern over nakedness as opposed to transparency or even balanced reporting. Nakedness in reporting is not synonymous with transparent reporting. Transparent reporting may not share the same characteristics as balanced reporting.

Your competitors know what you are doing. But do your stakeholders know what you are doing in terms of making money in a way that impacts the social and environmental landscapes? These are the people that want to invest in your company but they need to make an informed decision.

As important as it feels to be trumpeting what you, the organisation, are doing right, it is equally imperative to be transparent about what you are doing wrong, or doing badly.

In 2013, PriceWaterhouseCoopers (PWC) conducted a survey of 30 of the listed companies in Malaysia in hopes of sharing the “good news and bad news of what [these organisations] are already doing” in integrated reporting, “as a baseline of what [they] can do next.” The companies cut across sectors, from telecommunications to banking.

What was heartening to see, said one panellist was how those disclosures have been evolving over time. Despite the lament that corporates sometimes ask the question, “Does my company

really need to worry about the environment?" many of the basic ingredients for integrated thinking are in place.

These companies have a strategy and they have CSR in place and discuss at length about governance, risk and other processes.

The key missing link in this scenario is that companies are not linking the dots. Directors talk about strategy but they do not talk about business models or KPIs; they talk about risk but they do not explain them.

The other, though converse, discovery from this survey of Malaysian companies was that these organisations were not good – or used to – trumpeting their achievements when KPIs have been met, almost as if they are embarrassed to do so.

They have, as the panellist succinctly expressed, "a disjointed way of expressing [their] value."

In a Malaysian context, there is a need for examples of experiences of companies having linked the dots that is integrated reporting.

But companies do need to think about environmental impact, and not simply in the context of ecological overshoot and even in the absence of formal parameters of business impact set by governments or regulators.

Because of the finite nature of most natural assets, how will organisations create a business to meet increasing demand or create more demand but by using less resources?

This is the juncture at which INNOVATIVE THINKING becomes essential and companies have to employ information technology.

Hence, the explosive development of digital manufacturing; it could be in the next ten years that manufacturing could move from the Far East back to the west coast of America because digital manufacturing could replace manufacturing as we know it today with plants and machinery.

"There has to be a change of mindset and a change of thinking to learn to make more with less."

As soon as you learn to do so, you meet the needs of the environmentalists and you know it makes good business sense.

There is a need for businesses to see the opportunities that integrated thinking and integrated reporting provide.

"If you are not informing them, it then becomes an act of misinformation."

There is no good in reporting in a style, manner or content which is not understandable to the person in the street. Being transparent in reporting does not mean nakedness nor does it mean you've got to disclose everything, especially confidential information.

What integrated reporting means is balanced reporting: reporting the positives and the negatives. It is a natural human inclination to highlight the positives and downplay the negatives but in not informing, you are misinforming.

Famous Last Words

"Today there are greater expectations from stakeholders than ever before. Stakeholders will not support a company who they believe has made a profit at the expense of human rights, the degradation of the environment, or made an impact on society. They will react, and that is the reality."

Professor Mervyn E. King

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