Integrated Reporting for Turkish Small and Medium-Sized Enterprises

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Abstract

Ever-increasing complexity of financial markets drives businesses to focus solely on financial performance. Measures to evaluate such performance establish criteria on benchmarks like profit margin, return on assets and equity, earnings per share and others. While these measures reveal performance, numerical values may lack indication with regard to value creation. Changing trends in the market with regard to advancements in technology can simply jeopardize the sustainability of business. Additionally, loyal customers are often enticed by competitive business. Small and medium-sized enterprises (SMEs) which are usually the most vulnerable entities against financial distress, are being challenged the most in order to sustain their life spans. Financial performance as the only yardstick to evaluate the overall performance of businesses has become obsolete in today’s market conditions. Aim of this paper is to present the invaluable benefits SMEs can attain by shifting their focus from merely financial performance measures to a more holistic philosophy of thinking by implementing Integrated Reporting (IR).

Key words

Integrated Reporting, sustainability, financial reporting, SMEs, value creation

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1. Introduction

Current climate of financial reporting has abolished the myopic primary objective of businesses to merely focus on accounting earnings and shareholder wealth. News disseminate all over the world instantly thanks to advancements in cyber space. With such change, investors and governments progressively demand organizations to be more transparent and accountable. Stakeholders are affected more than ever with the engagements of businesses due to the fact that thanks to global integration, all elements of stakeholders ranging from governments to capital markets have unified ever more. As an important constituent, investors of today focus not only on financial performance, but also on the non-financial measures due to increased awareness on issues such as environmental concerns and ethical conduct of business. The transformation of investors’ perspective from a traditional investor who solely concentrates on financial performance to more aware investors who additionally concentrate on sustainability performance has triggered enterprises to rethink their use of resources and to report information that is relevant (Abeysekera, 2013).

With the latest financial crisis and corporate scandals, numerous individuals consider businesses as one of the main reasons of economic, social and environmental problems. Vast national debts especially topped with encouraged individual debts, high unemployment rates, rising inequalities within citizens, unethical management styles in enterprises and growing anxieties for the environment overall drive societies to be overly frustrated, irritated and dissatisfied about the current social and economic order. As a consequence, the concept of sustainability and corporate value creation have been significantly highlighted and become the present center of attention (Busco et al, 2013).

By extension, enterprises of all sizes perceive increased pressure both from investors and others to disclose their sustainability information (Gillan, 2013). Enterprises, particularly listed ones, have long been obligated to publish a report on annual financial statements and moreover they have been obliged to publish a report on corporate governance so that level of “good governance” could be identified.
Furthermore, enterprises voluntarily publish sustainability reports to show society and stakeholders the appropriateness of their corporate behavior concerning social and environmental features (García-Sánchez et al., 2013).

A number of leading companies have started to integrate all financial and sustainable information into a single document that creates integrated reporting for a sustainable strategy (Frias-Aceituno et al., 2014). Integrated Reporting (IR) gathers up material information concerning organization’s strategy, governance, performance and visions that represent its commercial, social, and environmental situation. IR projects to be a stand-alone, brief communication, which is connected to additional reports and details for stakeholders who desire more details about the entity in general (IIRC, 2011).

The purpose of this study is to introduce IR and its benefits for small and medium-sized enterprises (SME). Furthermore, the paper also discusses relevant literature and opportunities that are available for Turkish SMEs with regard to the applicability of such philosophy of reporting.

2. Literature Review

2.1. Integrated Reporting

The International Integrated Reporting Council (IIRC) explains IR “as a concise communication about how an organization’s strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term” (IIRC, 2013). Businesses and investors along with all the other elements of stakeholders can fundamentally benefit from IR. Businesses require IR to understand and express the suitable strategies for achieving performance and attract financial capital for investments. On the other hand, investors are able to examine the value creation, which the business forms thanks to IR since the chief characteristic of such holistic structure offers the framework that empowers businesses to devise long-term; rather than short-term decisions by offering a complete image of how value is created over time. Briefly, IR supports and contributes for building a stable economy and a sustainable world (www.theiirc.org). IR aims to collect material information (strategy, governance) and performance of a business. Integrated reporting differs from traditional annual reports since current reporting practices mainly concentrate on financial and commercial features, which lack social or environmental information that is in fact material to the business. On the other hand, IR offers an understanding of strategic focus of the business. Moreover, it clarifies how a business can generate and sustain value over the short, medium and long terms. It is important for enterprises to begin speaking and communicating about their financial position in a transparent manner (Magarey, 2012). Companies that employ this holistic philosophy of reporting will not only disclose transparent information, but will take a sharp step towards sustainability and value creation as well.

2.2. Development of Integrated Reporting

In 2009, His Royal Highness the Prince of Wales assembled a meeting to form IIRC with investors, standard setters, companies, accounting bodies and United Nations representatives. IIRC is a body to oversee the formation of a globally accepted international Integrated Reporting Framework. The IIRC conducted worldwide meetings in 2010 and 2011 for the development of IR. Additionally, IIRC also published the Discussion Paper and established a Pilot Program to assess the feasibility of implementing IR. Finally, in 2012 the IIRC Secretariat was established and by late 2013, IIRC published International Integrated Reporting Framework (www.theiirc.org). As of now, a large number of companies like HSBC, Renault, BASF, Philips, Axa and many others actively have employed IR.

2.3. Integrated Thinking

Investors, managers and other stakeholders began to recognize that factors that create value for a business are mostly intangible assets –both on and off the balance sheet–, which comprise of intellectual capital, human capital, environmental, social and finally governance issues. This situation is consistent with IIRC discussion paper in 2011. According to the discussion paper, while the physical and financial assets explained 83% of market value, this percentage went down to 19% in 2009. As seen by the numbers, value creation changes as years go by, and this means that emphasis of financial reporting must change. This goes to the center of integrated reporting. Integrated reporting moves the concentrate from traditional...
reporting and carries it on multiple levels by offering better communication and increased transparency (Magarey, 2012).

An essential requirement for IR is to accept and adopt integrated thinking throughout the organization (Ewings, 2013). Integrating thinking is a continuous process, which is associated with the ability of managing. Consequently, management should monitor and communicate the process of value creation and how it turns into success over time. The successful communication of this process can assist investors and stakeholders to comprehend and compare the past and the current performance (Welford, 2012).

3. SMEs and Sustainability

Statistics show that the Earth is being stressed and people are afraid that the Earth’s carrying capacity may be unable to sustain future generations if nothing is done to stop the trend. There are numerous reasons for the Earth to be stressed, but one of the main reasons is the business units. “Ecological footprint measures the amount of land and water that are capable of sustaining a person and absorbing emitted carbon dioxide.” According to 2007 data, worldwide ecological footprint in average is 2.70 hectares per person. Since the reality is like this, businesses should need to change their marketing attitude and business model to sustainability marketing and model, including Small and Medium-Size Enterprises (SMEs) that usually functions in the informal economies (Idoko, 2013).

Sustainability reporting has become an essential feature of external reporting by all size of enterprises. Enterprises of all sizes try to increase their efforts to attain sustainability and to protect resources for future generations. These efforts can be counted as lessening an enterprise’s environmental footprint, efficiently consuming, protecting resources, and interacting responsibly with stakeholders.

In this framework, SMEs have an important role. Even though SMEs might have small social, environmental and financial impacts, their cumulative impact is noteworthy. SMEs account for some 70% of worldwide production while they are representing about 99% of the total number of firms. SMEs are equivalent to millions of companies that includes 52 largest stock exchanges with 45,000 listed companies, 28 million private sector enterprises in Europe, 25 million in USA, 4.7 million in UK and 6 million in Brazil (Pacter, 2011). SMEs are contributed greatly to the development of the Turkish economy, as in the whole world. According to Ministry of Industry and Trade report in 2010, there are 3,449,795 Small and Medium-sized and 2,968 Large-size Enterprises in Turkey. SMEs constitute 99.9% of all enterprises. They generate 80.57% of employment, 58.48% of value added and 59.53% of total production value (RTMIT, 2010: Kaya, 2011).

In general, SMEs are accepted as a vital key for economic growth and development of a country, especially for emerging economies like Turkey. On the contrary, SMEs apply great pressure on environment, not individually, but as a whole. In total, SMEs around the world cause 60% of all carbon dioxide emissions and 70% of all pollution worldwide. That being the case, consumers’ demand progressively increases for safe, healthy, sustainable products and environment (Idoko, 2013). According to a study conducted by The Bank of England on why SMEs fail, six top reasons in order of frequency are mismanagement, poor assets, faulty structure, liquidity, dealing losses, and secrecy and fraud. Mismanagement to lead to bankruptcy received a high % 68.4 of all cases and financial reasons were % 31.6 of all cases (Chorafas, 2004). One other alarming fact about the nature of Turkish business environment is that it is made up of mostly family businesses with a very high % 95 (Yılmaz, 2004). There is evidence that family firms are ineffective in corporate governance. Family businesses fail to extend their existence to the next generations due to many evident reasons some of which are fraudulent conduct of business and lack of corporate governance. IR is vital in overcoming these deficiencies for the Turkish SMEs. Aware investors and other stakeholders change their attitude toward sustainability and they want to look at sustainability report together with financial report. For this reason, preparing a sustainability report becomes an initial condition for enterprises. Sustainability reporting generally related with reporting on limited resources of an enterprise and its effects on the environment. However, numerous enterprises additionally add information about human resource management and its effect on the community, suppliers, customers and other stakeholders (Marianne, 2013).
4. Sustainability for SMEs

Most of the SMEs do not always report their sustainability practices. This should not mean that those SMEs do not have sustainability practices but they are doing it on voluntary basis (Brilius, 2010). The reason behind this is some SMEs think reporting is costly. It is reasoned that adopting and helping environmental sustainability will increase the total cost of an SME. Also this increase in the cost will force them to adopt additional costs, which may be affect customers and consumers in the form of price increase. Generally, this thinking depends on the SMEs owner or manager belief. They think cost is connected with environmental management and there will be no adequate return of economic benefit to their businesses. Also in emerging economies, consumers and customers have limited disposable income and might be fail to afford such price increase (Idoko, 2013). SMEs give the impression that they are more flexible and closer to consumer demand then large firms. SMEs can convert these advantages to sustainability superiority; however limited resources like capital, knowledge and trained employees put boundaries for sustainable practices (Brilius, 2010).

Customers expect and require that companies perform responsibly. Therefore, reporting of sustainable practices lean toward target customers. As loyalty of a customer is crucial to longstanding survival for all size of enterprises, reporting sustainable practices is extremely significant (Marianne, 2013). According to Strategic Sustainability Consulting report in 2010, there are 8 benefits of sustainability reporting. These are cutting costs, improving employee morale and retention, creating marketing and branding advantages, anticipating the future demands of customers and regulators, understanding pressures from nongovernmental organizations, greater credibility as part of the supply chain for larger corporations, organizational commitment and stakeholder engagement.

Sometimes changing small and simple details to protect environment might end up with fast cost savings. For instance, countless SMEs usually buy energy saving or energy efficient equipment, which lessens costs and preserve energy. This practice lessens the impact on the environment, protects resources for future generations and helps for sustainable growth (Marianne, 2013). Investors and other stakeholders reward this kind of action by buying the products of the business or by investing in it. This is valid for all size of enterprises. SMEs are lucky, since they can have direct and very noticeable relationship with their customers, creditors and investors. By sustainable practices, stakeholders might have larger influence on the perceptions, loyalty and goodwill toward an enterprise. Likewise, some companies desire to choose suppliers that apply sustainable practices (Marianne, 2013).

Many SMEs publish their sustainable practices. However, they generally do not publish formal reports, which make a difference with larger companies. SMEs believe and consider that formal reporting is costly and cannot get considerable benefit. Though, formal reporting of sustainable practices results with important benefits for SMEs, if it is used together with financial reporting, which it is called an integrated reporting (Marianne, 2013). Bringing together financial data with intangible information might improve the view on SMEs’ creditworthiness (Mertins and Orth, 2011).

5. SMEs and Integrated Reporting

“The world has changed, reporting must too”. These are the words of HRH the Prince of Wales for introducing integrated reporting. Purpose of integrated reporting is to form internationally accepted framework for accounting of sustainability that gathers up financial, social, environmental and governance information in a single or integrated format (Mertins et al., 2012).

Integrated reporting offers an outline for entities how to show stewardship, how to create and sustain value. It combines material information, concerning enterprise’s strategy, governance, performance, and prospects that reveals its social, commercial and environmental setting. Integrated reporting is a process and it requires integrated thinking and integrated management (Prinsloo, 2012).

The principles that are attached to integrate reporting are applicable to all companies regardless of size. SMEs are tending to have greater degree of integrated thinking. According to IIRC “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. Integrated thinking leads to integrated decision-making and actions that consider the creation of value over the short, medium and long term. “Also, SMEs are advantageous since it should be easy for application of the principle of connectivity.
Integrated reporting is mainly pointed at investors, but it is also beneficial to other stakeholders. Benefits can be counted as, reputation between stakeholders, earning trust from funders, increasing the brand value, lowering cost of capital, improving customer and employee support and loyalty (Prinsloo, 2012).

Within integrated reporting, SMEs will improve their strategies, recognize how strategy touches environmental, social, financial and economic topics, and improve risk management, strategic decision-making and performance. Also, SMEs can discover new opportunities in their products and services (Prinsloo, 2012).

All size of enterprises relies on different resources for their success. IIRC uses the “multiple capitals” to clarify how a business creates and sustains value. An integrated report should present the stewardship of a business not just for financial capital, but also for manufactured, human, intellectual, natural, social capitals and their interdependences (Mertins et al., 2012).

According to the IIRC, integrated reporting relies on five principles, which are strategic focus, connectivity of information, future orientation, responsiveness and stakeholder inclusiveness, and conciseness, reliability and materiality. Also, integrated reporting relies on six elements, which are organizational overview and business model, operating context, including risks and opportunities, strategic objectives and strategies to achieve those objectives, governance and remuneration, performance and future outlook (IIRC, 2011). Investors’ and other stakeholders’ interest in reporting shifts from traditional reporting to Integrated Reporting. The differences between two reporting are shown in the table (www.accountingforsustainability.org).

<table>
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<tr>
<th>Thinking:</th>
<th>Disconnected</th>
<th>→</th>
<th>Integrated</th>
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<tr>
<td>Stewardship:</td>
<td>Financial capital</td>
<td>→</td>
<td>All forms of capital</td>
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<tr>
<td>Focus:</td>
<td>Past, financial</td>
<td>→</td>
<td>Past and future, connected, strategic</td>
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<td>Timeframe:</td>
<td>Short term</td>
<td>→</td>
<td>Short, medium and long term</td>
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<td>Trust:</td>
<td>Narrow disclosures</td>
<td>→</td>
<td>Greater transparency</td>
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<td>Adaptive:</td>
<td>Rule bound</td>
<td>→</td>
<td>Responsive to individual circumstances</td>
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<td>Concise:</td>
<td>Long and complex</td>
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Figure 1. Traditional Reporting versus Integrated Reporting

It is expected that SMEs would not be obligatory to create an integrated reporting, but rather they will be encouraged to do so. The reason behind this can be shown as the integrated reporting is originally designed for larger companies. No wonder it will be cascaded down to SMEs. IFRS is an example of this situation. Even though integrated reporting is not required for SMEs, market pressure across the supply chain will probable to cause larger companies to require integrated reporting for SME suppliers to achieve their own integrated reporting commitments (Druckman, 2011). The statistics below show that even though, integrated reporting is not obligatory SMEs, large and multinational enterprises started to publish integrated reports around the world. SMEs provide 7-9% of self-declared integrated reports each year (GRI, 2013).

Figure 2. Size of organizations publishing self-declared integrated reports (%)
In the discussion paper of 2011, IIRC has asked question if integrated reporting is applicable to SMEs. The question is “Do you agree that the concepts underlying Integrated Reporting will be equally applicable to small and medium enterprises, the public sector and not-for-profit organizations?” The results are published in 2012 discussion paper. According to the discussion paper 56% of the respondents agreed, and another 16% agreed with some qualifications. Although, most of respondents agreed that integrated reporting is applicable to SMEs, others thought that it is not necessarily apply “equally” to all sizes and types of businesses. The opposing views suggest that SMEs has “insufficient data to prepare such a report, lack of staff to obtain, analyze and prepare information and additional administrative burden. “However, the IIRC expects that Integrated Reporting will be equally applicable to small and medium-sized enterprises, the public sector and not-for-profit organizations (IIRC, 2011).

6. Conclusions

As the International Financial Reporting Standards (IFRS) emerged to respond to the changing trends in financial reporting, the International Accounting Standards Board (IASB) soon felt the need to customize a set of accounting standards specifically dealing with the needs of SMEs. Similar transition is needed for IR, which explicitly defines the necessities of SMEs. For Turkish SMEs, it will be cost efficient to create one single report and implementation of IR will increase transparency. It will also provide information about governance, strategy, and economic, social and environmental factors. The first action must be to increase awareness of integrated reporting among SMEs. Furthermore, members should be trained to help SMEs in the process, create a channel of communication with stakeholders and support the application tools for SMEs. On the other hand, SMEs should get organized and make plans about integrated reporting process (Prinsloo, 2012).

According to IIRC, IR will benefit Turkish SMEs to the extent that it simply aims at better articulation of strategy for the business and examining how the set business model is responding to the ever-changing trends in the marketplace. Plus, IR will aim at establishing better dialog among all the key players ranging from the business all the way to the financial capital. For investor point of view, “investors are able to assess more effectively the combined impact of diverse factors, the disclosure of key risks and opportunities as management views them enables investors to assess the short, medium and long term impact, and more effective capital allocation decisions leading to better long-term investment returns” (IIRC, 2011). No time delays are expected to take place between two reports, since IR publishes only one single report (Ewings, 2013). It will support and assist SMEs to think of the joint influence of their engagements within the scope of economic, natural, and social environment. This will assist SME managers to improve strategies and business models that promote sustainability and concentrate on the long-term value creation. IR will provide valuable information for SME executives to assist them in planning, budgeting, and implementing strategies that give rise to the efficient and effective consumption of resources, which will be inclined to reduce costs. IR will more over expand SMEs’ capability to successfully communicate with external stakeholders, who progressively want companies to apply and improve sustainable and responsible actions. Additionally, it will increase customer and employee loyalty that can possibly cause additional financing opportunities (Marianne, 2013). As a concluding remark, Turkish SMEs are expected to acquire great enhancement in terms of sustainability and value creation thanks to the holistic philosophy, which IR aims at establishing.

References

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