The “Business Model” concept in Integrated Reporting

This IR Update comprises the following:
- To propose a definition of the term ‘business model’ for IR
- To provide guidance on how to disclose the business model in an IR
This paper summarises the business model background paper released by the International Integrated Reporting Council (IIRC) in March 2013. The IIRC is considering this paper in the development of the International Integrated Reporting (IR) Framework Consultation Draft. For a copy of this paper, please refer to the IIRC’s website: www.theiirc.org/resources-2/framework-development/background-papers/

Summary of the IIRC’s paper on the business model

Relevance of the ‘business model’ for IR:
The Prototype of the International <IR> Framework released in November 2012 suggests the inclusion of a description of an organisation’s “business model” in the IR. This description should include how the organisation’s business model relates to the organisation’s strategy, governance, performance and future outlook. Such a disclosure is deemed to help an investor make a “meaningful assessment of the long-term viability of the organisation’s business model and strategy”.

Definition of the ‘business model’ for IR:
The IIRC’s paper defines a business model as the organisation’s chosen system of inputs, business activities, outputs and outcomes that aims to create value over the short, medium and long term.

Position of the “business model” relative to other IR content elements:
The business model sits at the heart of the organisation, but is interconnected with the other content elements. This is reflected in the diagram below which illustrates a business model in which the inputs (i.e. various types of capital e.g. financial, natural, human etc.) are transformed through business activities into outputs (i.e. products or services) in order to create a particular outcome in terms of the effects on the capitals and the value ultimately created or destroyed.

The diagram above also illustrates the interconnectedness between the capitals, the business model and the internal and external environments: It is through continuous monitoring and analysis of external factors in the context of the organisation’s mission and vision that key opportunities and risks are identified. Subsequently, a strategy is formulated that sets out the long-term objectives and resource allocation plans that determine how to maximise opportunities whilst managing and/or mitigating risk. The recording, measurement and monitoring of performance information enables decision-making and performance improvement.
Reporting example:
The figure below as included in the business model background paper provides a practical example of how business model disclosures can be organised.

<table>
<thead>
<tr>
<th>Inputs</th>
<th>Business Activities</th>
<th>Outputs</th>
<th>Outcomes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Capitals which may take the form of:</td>
<td>▪ Research and development</td>
<td>▪ Products</td>
<td>▪ Customer satisfaction</td>
</tr>
<tr>
<td>▪ Funding model</td>
<td>▪ Planning</td>
<td>▪ Services</td>
<td>▪ Profit/Loss</td>
</tr>
<tr>
<td>▪ Infrastructure</td>
<td>▪ Design</td>
<td>▪ Waste</td>
<td>▪ Shareholder return</td>
</tr>
<tr>
<td>▪ People</td>
<td>▪ Production/ conversion</td>
<td>▪ Other by-products</td>
<td>▪ Asset consumption</td>
</tr>
<tr>
<td>▪ Intellectual property</td>
<td>▪ Product differentiation</td>
<td></td>
<td>▪ Contribution to local economy through taxes</td>
</tr>
<tr>
<td>▪ Raw materials</td>
<td>▪ Market segmentation</td>
<td></td>
<td>▪ Job creation</td>
</tr>
<tr>
<td>▪ Ecosystems services</td>
<td>▪ Distribution</td>
<td></td>
<td>▪ Employee development and engagement</td>
</tr>
<tr>
<td>▪ Relationships</td>
<td>▪ Service provision</td>
<td></td>
<td>▪ Improved standard of living</td>
</tr>
<tr>
<td></td>
<td>▪ Quality control</td>
<td></td>
<td>▪ Environment impact</td>
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<tr>
<td></td>
<td>▪ Operational improvement</td>
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<td></td>
<td>▪ Relationship management</td>
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<td></td>
<td>▪ After-sales service</td>
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</table>

Reporting considerations:

- **Inputs**: Focus on those aspects that have a material bearing on the organisation's ability to create value in the short, medium and long term, considering the entire value chain and not only aspects owned or directly controlled by the organisation. Ways of enhancing the report users' understanding of its use of the various types of capital include, for example the following:
  - *Financial capital*: provide an overview of its funding model, such as debt, equity or grants.
  - *Manufactured capital*: Explain how facilities, equipment and other infrastructural components lend operational efficiency and effectiveness in the form of productivity, cost containment, enhanced safety and environmental stewardship.
  - Explain reliance on external infrastructure and any risk to its continued existence as this can affect the long term success of the business model.
  - *Intellectual capital*: Explain how brands, patents, copyrights, proprietary knowledge and other forms of intellectual property create value. Also note any limitations or limited lifespan of these value creators.
  - *Human capital*: Explain the key skills and experience of staff and how skills are maintained, such as through training and development programmes.
  - *Social and relationship capital*: Provide an explanation of the network of partnerships and stakeholder relationships upon which the organisation relies, as well as programmes designed to develop and enhance these interactions.
• **Natural capital:** Describe the key natural resources and ecosystem services upon which the organisation relies. Where critical supplies or ecosystem services are expected to improve or erode, the organisation should explain its general course of action. If significant environmental remediation efforts are expected to occur, those activities should also be explained.

- Outputs: Disclose a description of the key products and services, including waste and other by-products, insofar as they are material.

- Outcomes: Disclose key outcomes or consequences resulting from business activities, including those internal or external to the organisation, considering the entire value chain and not only aspects owned or directly controlled by the organisation.

- Business activities: include an explanation of the different types of key business activities such as the following:
  - Activities that convert inputs into outputs e.g. planning, design and manufacture of products or the deployment of specialised skills and knowledge in the provision of services.
  - Initiatives that influence the effectiveness and efficiency of business activities e.g. process improvement, employee training and relationships management.
  - An explanation of how the organisation differentiates itself in the marketplace through product differentiation, market segmentation, delivery channels and marketing.

- Identify and explain critical vulnerabilities in the business model as well as its responsiveness to change.

The paper provides examples of how to enhance the effectiveness and readability of the business model in the IR, for example:

- Explicitly identify the key elements of the business model within the narrative using common, identifiable terminology and headings.
- Include a simple diagram highlighting key elements of the business model, supported by a clear explanation of the relevance of those elements to the organisation.
- Ensure that the narrative addresses all material matters and is logical given the organisation's circumstances.
• Identify critical stakeholder and other dependencies, key value drivers and important external factors, including factors over which the organisation has control.
• Clearly explain the organisation’s positioning within the entire value chain.
• Connect the business model to other aspects of reporting, including strategy, opportunities and risks, key performance indicators and financial considerations like cost containment and revenues.

Organisations with multiple business models
Organisations that have multiple types of business models and/or operate in different market segments may face a challenge in deciding how to depict their business model simply and concisely. The paper suggests that in deciding how to depict the business model, the organisation bears in mind the interests and decisions made by the long term investor.

In doing so, the IR should provide an effective explanation of how the organisation operates as a whole and in its separate parts (including the interconnectivity between the various aspects of the overall business model). The paper also suggests that aligning external reporting with internal reporting is nearly always appropriate, even for the most complex of organisations.
Key contacts that can assist you in your IR journey

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