

EDITED BY CHIARA MIO

INTEGRATED REPORTING

A NEW ACCOUNTING DISCLOSURE



Integrated Reporting

Chiara Mio
Editor

Integrated Reporting

A New Accounting Disclosure

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Editor

Chiara Mio
Ca' Foscari University
Venice, Italy

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Foreword

Preface by Paul Druckman, Chief Executive Officer, International Integrated Reporting Council.

The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs. The coalition is promoting communication about value creation as the next step in the evolution of corporate reporting.

Organizations looking to evolve their approach to corporate reporting need evidence that has academic rigour so they can see for themselves the effects of Integrated Reporting in terms of market performance, giving them the overall picture. That is why this book is so important for IR, to build on the extraordinary momentum that has been building over the last few years. Demonstrating, for example, the belief by investors that IR has the potential to be the future of corporate reporting.

This book enables me to understand, as CEO of the IIRC, what we should be focusing on and what the market needs from us as we advocate corporate reporting reform.

A lot has changed since the turn of the millennium. Technology has developed faster than anyone could have imagined. Globalization has well and truly taken hold. The global financial crisis has taught us that the world is inextricably interconnected in a way that had not previously

been understood. These are just three of many aspects of everyday life that are unrecognizable from fifteen years ago.

Corporate reporting has not evolved so rapidly. But change is now well and truly underway because of the recognition that reporting must adapt in order to stay relevant. It is clear now that to communicate an organization's value effectively more is needed than only the reporting standards that were developed in the last century.

Accountancy is a forward-looking profession that, when encouraged to do so, has a great capacity to anticipate change and put into practice innovations that serve the public interest by seizing upon business and societal trends, and translating them into practice for the marketplace to advance the greater economic good.

In Renaissance Tuscany in 1494, the mathematician, author, scholar and monk Fra Luca Pacioli brought together all the existing accounting practices and published a 27-page thesis, which became the foundation of double-entry book-keeping and which remains a staple of accountancy teaching and practice today.

From here the accountancy profession evolved the accounting ecosystem to include personal ledgers, accruals and prepayments, and many more developments. They responded to the needs and expectations of the capital market at a point in time, such as the agricultural revolution and the industrial revolution.

In the twentieth century, the necessity for corporate reporting emerged due to rapid economic expansion. Furthermore, the globalization of capital markets led to the introduction of new market regulators, standards boards, legislation and regulation in accounting and corporate reporting. By the late twentieth century, the design of the system had become too rigid because it was coupled in with implementation and oversight which had been imposed across most of the world's major capital markets, with innovation in corporate reporting no longer developing as freely in response to market trends.

IR is a market-led response to the corporate reporting challenges of the twenty-first century. Businesses require an evolution in the system for reporting, facilitating and communicating mega-trends without the complexity and inadequacy of out-of-touch reporting requirements. Currently, there are significant information gaps in reports, with

organizations such as the World Bank, the G20's Financial Stability Board and the International Monetary Fund calling for a greater focus on aspects such as risk and future development.

Times of difficulty are often catalysts for the innovative business opportunities of tomorrow to take hold. And although there were many people pushing for corporate reporting reform prior to the 2008 global financial crisis, it was the catalyst that made this a mainstream issue for many businesses around the world. The crisis caused businesses to realize that they need to communicate more than financial information and that they need to offer this information in a concise and clear way.

Before the crisis, few would have believed that the selling of a mortgage to an unsuitable applicant in the suburbs of Chicago could be going down a bank in Ireland or Iceland—but it could, and it did. The crisis demonstrated the undeniable interconnectedness of global markets. What IMF Managing Director Christine Lagarde described as the “breakneck pattern of integrated and interconnectedness that defines our times” brings with it tensions in economic sustainability. This complex interplay of connections creates heightened risks and untapped opportunities for economies, businesses and investors alike. Organizations such as the IMF and the World Economic Forum are calling for new systems and models that respond to a world in which risks and opportunities cannot be isolated. Reporting practices must enable organizations to effectively communicate how they manage the risks they face, and how they use all of their interconnected resources and relationships to create value.

One reason for a lack of broader, multi-capital, thinking in corporate reporting prior to 2008 may well be the sense of reporting fatigue that grasped many businesses. As financial and other reporting standards evolved, reports became more voluminous and so potentially less helpful for information users who are looking for a more complete picture and an understanding of the company's strategy for the future. For many businesses, the annual report became a tick-boxing exercise with ever increasing amounts of reports ending up on shelves gathering dust rather than in the hands of those who should be using them to inform decision making. As a recent article in the Wall Street Journal identified, General Electric's Annual Report is 109,894 words long, which, when you consider Harry Potter and the Philosopher's Stone is 76,944 words, is verbose. General

Electric's Financial Chief himself said, "Not a retail investor on planet Earth could get through it, let alone understand it." In recent years, calls for a rationalization and reduction in the reporting burden have become louder and more widespread. As Professor Judge Mervyn King, Chair of the IIRC said, "To be accountable and transparent that which we report needs to be understandable. To report in an incomprehensible manner for 99.9% of users of an annual report results in knowledge that is lost in a mass of information. And I'm afraid that's what we've all been guilty of for decades."

There are great opportunities for this new concise form of reporting to become a reality. Not least if we take advantage of the digital revolution which has swept across the world thanks to the success of cloud, social and mobile technologies. Although this revolution has created new challenges for businesses as they deal with faster and vaster flows of information both inside the company and externally with stakeholders, if harnessed properly it can bring new meaning to the corporate reporting process as businesses get used to the new world of real-time engagement with stakeholders.

So whilst it's clear there have been many catalysts for corporate reporting reform—what's the end game? Why does corporate reporting need to keep up—what is its importance? The IIRC believes that corporate reporting reform can help align capital allocation and corporate behaviour to the wider goals of financial stability and sustainable development.

While financial reporting helps to provide confidence in the narrow past financial performance of the business and the ability of management to execute strategy in the short-term, reporting on broader factors orients the company in the present *and the future*, enabling an investor or potential investor to take a much longer-term view, attracting capital to industries and sectors of the economy that will power future growth, such as infrastructure, technology and bioscience. Information about how these stocks of capital are being managed over the business cycle will provide much needed insight into the future financial viability of the organization.

For obvious reasons corporate reporting reform alone will not bring about financial stability and sustainable development. The work of the IIRC goes hand in hand with other efforts around the world, which is

why we are working through our networks and within our coalition to encourage three shifts. Firstly, a shift from a financial capital market system to an inclusive capital market system. We are encouraging governments, central banks, stock exchanges and standard setters to recognize the interconnection between elements such as finance, knowledge and other resources, and embed systems of governance that enable this. An inclusive system means extending accountability beyond financial transactions, recognizing that society impacts business. An inclusive systems seeks to enhance the value to the business of all economic, human, social and environmental resources and build an understanding of the decisions and trade-offs that are made over different time horizons that impact an organization's strategy and business model.

The second shift the IIRC is calling for is from short-term capital markets to sustainable capital markets—to end the incentive systems that perpetuate short-term thinking and decision-making. Mainstream policymakers are entering the debate about changing the capital markets system to promote more long-term behaviour. The Bank of England's Andrew Haldane has challenged company law in the UK and other countries that gives primacy to the investor over other stakeholders. His argument is that investors cannot be the guardians of the long-term interest when the average share in the average company is held for less than seven months today, compared to over seven years in 1950.

US Presidential candidate Hilary Clinton has set out more than 15 policy solutions including changing the capitals gains tax regime to promote longer-term investment. She also proposed an end to the “tyranny of the quarterly earnings report”, which she argued distorts business decisions.

I believe that Stewardship Codes, with clear principles and institutional support within countries, can deliver important incremental improvements to corporate governance and specifically lead to a better and deeper flow of information between the board and institutional investors based on the business model, strategy and value creation over the short, medium and long term.

And finally, the third shift is from silo reporting to IR. The IIRC has convened the Corporate Reporting Dialogue which brings together the major international reporting standard setters. It is an initiative designed

to respond to market calls for greater coherence, consistency and comparability between corporate reporting frameworks, standards and related requirements. Through the Dialogue the participant's aims to communicate about the direction, content and ongoing development of reporting frameworks, identifying practical ways and means by which respective frameworks and standards can be aligned and rationalized.

The IIRC is leading the drive to bring about a corporate reporting system that is both principles-based and cohesive, and urging policymakers to remove all regulatory barriers to IR adoption and introduce policies that are consistent with its principles of connectivity of information, multiple capitals and future orientation. Together these three shifts can be a force for financial stability and sustainable development in markets around the world.

For many the third shift towards IR is already a reality. There are currently around 1000 businesses around the world who are using the International IR Framework to think holistically about their strategy and plans. Many of them—around 750—engage with the IIRC through IR Networks to advance corporate reporting together, learning from each other to find the best ways of moving towards IR. Over 180 reports have come out of Japan alone in 2015.

Those that have already embraced IR and all that it has to offer are the innovators—the first movers—they have seen an opportunity and acted on it, without the reassurance of being part of a crowd.

The businesses that produce integrated reports have spotted the opportunity in communicating a clear, concise, integrated story that explains how all of their resources are creating value. The investors that are demanding these reports are aware of the benefits to their investment models of considering more than just financial information. And the regulators, standard setters, accountants and NGOs that are supporting the evolution of corporate reporting all recognize the importance of using IR to align capital allocation and corporate behaviour to wider goals of financial stability and sustainable development.

Other organizations are—quite understandably—more cautious by nature about evolving their approach to corporate reporting, which is why the evidence and insights provided in this book are so important in giving them the impetus to take the next steps.

I have known the editor of this book, Professor Mio for ten years now and she has been a significant factor in the thinking behind IR and the strategy of the IIRC. I am grateful for her support along the way, and to all of the contributors to this book, for playing a part in keeping corporate reporting in sync with the market needs of today.

Preface

This book intends to contribute to the fast-growing international debate on Integrated Reporting (IR) from an academic perspective. In particular, it discusses the International Integrated Reporting Council (IIRC) Framework and its implementation, analyses the determinants of IR, and looks at the effects of IR in terms of market performance and the adoption of management tools. It also provides an updated representation of current IR adoption practices and prospective developments for the future. Current academic literature is in need of research that provides an overall picture of IR and focuses on its determinants, consequences and future challenges. Academic literature on IR is increasing at a fast pace yet still lacks a comprehensive framework (for instance, in terms of theories the research on IR should be grounded on).

One of the central concepts of the book is corporate reporting, which we define as corporate disclosure focused on the organization's ability to create and sustain value over time. Corporate reporting relies on the *integration of* rather than the mere *addition to* the already existing reports issued by companies (for instance: the annual report, sustainability report, CSR report etc.). This integration is based on a process that starts from the strategy and reshapes the whole corporate disclosure system accordingly, from an integrated thinking perspective.

Integration allows the maximization of value creation both inside and outside the company while avoiding some of the potential shortcomings

of simply adding different reports. While the addition of reports may decrease the actual or perceived consistency of the information disclosed, integration helps companies maintain that consistency, both internally and externally. Besides this, the integration process “forces” companies to implement a materiality determination process, which requires those charged with governance to prioritize the different issues faced by the company. This activity lowers the amount of non-material information disclosed, and this is central to avoiding information overload or misunderstanding in investors.

IR focuses on capitals, rather than on stakeholders. This represents a strong similarity with corporate reporting, rather than sustainability reporting, which is created around the concept of stakeholders. Moreover, the IR materiality determination process focuses on the providers of financial capital rather than on the wider range of stakeholders. IR’s orientation towards providers of financial capital has been criticized by some, both in the academic and practitioner fields, but we believe that taking an investor perspective is a necessary first step in order to reach full integration among capitals. Without such an indication of priority from the IIRC, there cannot be an evolution of corporate disclosure, even through discussion and debate between different stakeholder groups.

Because of these reasons, we interpret IR (as defined by the IIRC Framework) as an evolution of corporate reporting. More insights specifically about the nature of IR can be found in Chaps 1, 5 and 6.

The book discusses some of the most important and challenging issues IR will have to face in order to become a widely used framework for corporate disclosure. Arguably, materiality and connectivity are, from this perspective, two of the most challenging IR principles. Determining the material issues, and drawing connections between them and between capitals, is an activity that requires great judgement by corporations and must be tackled by top management (those in charge of governance). Moreover, non-financial information and IR need credibility-enhancing mechanisms, to avoid greenwashing effects, one of the main shortcomings of sustainability reporting. In this sense, assurance may be very useful to companies in enhancing the credibility of information contained in IR.

Investors are arguably one of the main audiences for IR, and it is of paramount importance that they be able to assimilate the information

disclosed in the reports. Empirical evidence included in the book shows that investors believe IR has the potential to be the future of corporate reporting, but, at the same time, they are not fully satisfied with the way companies are implementing their IRs. The basic challenge for IR is probably the ability to gain the trust of investors (especially long-term oriented ones).

Given the marked future orientation of IR, companies will have to carefully consider the risk of generating an expectation gap. In other words, companies disclosing much about future events and performance in a certain year will be subject to investors' scrutiny to a higher extent the following year. Therefore, one of the challenges IR poses to companies is how to reach the adequate level of future-orientated disclosure.

Chapters 1, 2, 3, 4, 5, 6 and 7 focus on the IIRC Framework and its implementation. Chapter 1 offers a review and discussion of the most important guiding principles and content elements, which are the backbone of the IIRC Framework. It also compares the Framework with the main sustainability-reporting standard, the Global Reporting Initiative (GRI) Guidelines. Chapter 2 examines the current practice of reporting on strategy and business models. It draws on the guidelines for strategy and business model reporting proposed by the IIRC, as well as relevant literature on strategy and business models, in order to discuss some recent reports illustrative of the guiding principles. Chapter 3 analyses the concept of value creation the IIRC expresses in its framework and provides a comparison with value concepts that have been developed in academic literature and by different institutions, such as Shareholder Value, Stakeholder Value, Shared Value and Public Value. Chapter 4 looks at the evolution over time of companies' implementation of the IIRC framework, through an empirical analysis on IR disclosure quality over time. Chapter 5 examines the paradigm underlying the emergence of IR, and its relation to the two divergent paradigms underlying current corporate reporting practice, that is, financial reporting and sustainability reporting. Chapter 6 contextualizes IR in the broader realm of international financial and sustainability accounting standards. Chapter 7 provides a discussion of two Brazilian companies (Natura Cosméticos and Itaú Unibanco) in the light of the IIRC Framework and in particular of the concept of capitals.

Chapters 8, 9 and 10 study the determinants of IR. More specifically, these chapters provide a detailed discussion of the role of institutional investors (Chap. 8), corporate governance systems (Chap. 9), and institutional variables (Chap. 10) on a company's decision to produce an IR and/or on its quality. The analysis is particularly relevant because IR is principle-based, and the IIRC framework allows for significant variability in the way companies implement their IRs. A deeper understanding of the factors influencing such variables is central to academics, companies and, most importantly, policy makers. The IIRC may want to take into account the factors influencing the way companies implement the Framework.

Chapters 11, 12, 13 and 14 are related to the effects of IR in terms of market performance and adoption of management tools. In particular, Chap. 11 investigates the link between the choice to adopt IR and Enterprise Risk Management (ERM), finding that the number of companies filing an IR and contemporaneously adopting ERM is increasing over time. Chapter 12 looks at the effect of IR adoption on communication with the market through the channel of conference calls. Chapter 13 provides a theoretical discussion on the relationship between IR and the cost of capital, showing why and how IR may lower the cost of capital. Chapter 14 deals with assurance and other credibility-enhancing mechanisms, which are central to fostering the reliability of information and therefore increasing its relevance to investors and other stakeholders.

Finally, Chap. 15 discusses the expectation gaps generated by IR and, more broadly, the motivations that pushed companies toward IR, the difficulties in its implementation process, and finally, the opinions of investors.

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Notes on Contributors

Ricardino Alvaro is Professor of Accounting at Pontifícia Universidade Católica de São Paulo, he specializes in IFRS for small and medium-sized companies and with research interests in the history of Brazilian accounting. He is creator of the Prêmio Transparência (transparency award), awarded to the best financial reports published in Brazil. Professor invited by FIPECAFI, which is a Brazilian institute of finance and accounting.

Richard Barker is Professor of Accounting at Saïd Business School, University of Oxford, where he also serves as Academic Director of the Oxford MBA and Tutor in Management at Christ Church. His research interests are broadly in the area of corporate reporting and standard-setting.

Giorgio S. Bertinetti is Professor of Corporate Finance in the Department of Management at Ca' Foscari University of Venice. A former Head of the Department, he is currently the Director of the Risk, Sustainability and Company Performance Measure Lab, which he co-founded in 2014.

Nelson Carvalho is Professor at the School of Economics, Business and Accounting at Universidade de São Paulo, Brazil. His areas of investigation are corporate environmental, social and governance reporting; international and financial accounting; assurance and auditing; and financial reporting controls. Nelson is a member of the International Integrated Reporting Council.

Elisa Cavezzali is Associate Professor of Financial Markets and Institutions at Ca' Foscari University. She received her PhD in Business Management from Ca'

Foscari and she earned a second PhD in Finance from Cass Business School, London. Her main research interests include the financial analysis industry, financial disclosure, behavioural finance and financial literacy, and enterprise risk management.

Marco Fasan, PhD is Assistant Professor at Ca' Foscari University, Venice. He teaches management accounting (bachelor degree) and advanced management accounting (master degree). His main areas of interest are accounting, corporate governance and IR.

Giovanni Fiori is Full Professor of Business Administration and Internal Audit and Corporate Governance at LUISS Guido Carli University of Rome. He is the Academic Coordinator of the Double Degree in International Management—DDIM—with Fudan School (Shanghai) and a member of the Supervisory Board of Bank of Italy.

Gloria Gardenal is Assistant Professor of Corporate Finance at Ca' Foscari University of Venice's Department of Management. Her main research interests are corporate risk management and investors' decision making. She is a member of the Risk, Sustainability and Company Performance Measure Lab and of the Center for Experimental Research in Management and Economics (CERME).

Axel Haller is Full Professor and holds the Financial Accounting and Auditing chair at the University of Regensburg, Germany. He is head of the working group Integrated Reporting of the Schmalenbach-Gesellschaft für Betriebswirtschaft e.V. He has published multiple articles and books on various areas of accounting and corporate reporting.

Hien Hoang is a PhD candidate and casual academic at UNSW Australia Business School, who teaches Financial Accounting. Her primary research interest is in IR and assurance, sustainability reporting, and how these forms of extended information impact stakeholder behaviour and investment decision making.

Nazim Hussain PhD, He has recently joined as assistant professor of accounting in the department of accounting at the University of Groningen, The Netherlands. His research interests are in the fields of corporate governance and corporate sustainability performance and reporting analysis.

Maria Federica Izzo PhD is Assistant Professor at LUISS Guido Carli University of Rome, where she teaches Advanced Management Accounting and Business Administration. Previously she was a visiting scholar at Jones Graduate

School of Management, Rice University, Houston, and a research assistant at London Business School.

Timotius Kasim is a DPhil candidate at Saïd Business School, University of Oxford. Timotius holds an MSc (Distinction) in Accounting, Organisations and Institutions from LSE. His research interest is in environmental accounting and environmental reporting.

José Roberto Kassai is Professor at the School of Economics, Business and Accounting at Universidade de São Paulo, Brazil. His areas of investigation are corporate environmental, social and governance reporting and financial reporting controls. Kassai is coordinator of NECMA/USP.

Moreno Mancin (PhD in Business Administration) is Lecturer and Assistant Professor of Business Administration at Ca' Foscari University. He is Director of the Masters in Sport Business Strategies organized by Benetton Group in partnership with Ca' Foscari University since 2005. His main research and educational areas are financial and management accounting, international accounting, management of professional sport organizations.

Carlo Marcon, PhD is Assistant Professor in Financial Accounting at Ca' Foscari University of Venice, where he currently teaches Business Administration and Financial Statement Analysis. His areas of research interest are international accounting, corporate disclosure and accounting for financial instruments. He also lectures in several MBA programs and he is director of the Master in Internal Audit at Ca' Foscari University.

Chiara Mio is Full Professor at Ca' Foscari University, Venice. Prof. Mio teaches corporate reporting, management control in international firms and sustainability management. She is the Chair of the Board at FriulAdria bank and a member of the Sustainability Party at Federations des Experts Comptables Europeens (FEE). Her areas of interest are sustainability, management accounting and IR.

Fernando Dal-Ri Murcia is Professor of Accounting in the Faculty of Economics Administration and Accounting at University of São Paulo, Brazil. He holds a PhD in Accounting and Controllershship at the University of São Paulo. His research interests fall mainly in the field of financial reporting, regulation and international accounting.

Ugo Rigoni PhD is Full Professor of Financial Markets and Institutions at Ca' Foscari University, where he is the Dean of the School for executive education and lifelong learning (Ca' Foscari Challenge School). His research interests lie in

investment services and securities industry, mainly from the behavioural finance perspective.

Roger Simnett is a Professor of Accounting and Academic Director, Centre for Social Impact, UNSW Australia Business School. He has published on auditing/assurance in many leading journals and sits on many international standard-setting bodies, including the International Auditing and Assurance Standards Board 2002–2005 and the International Integrated Reporting Council working group 2011–2014.

Marco Vedovato is a researcher at Ca' Foscari University, Venice. His research interests are in strategy tools, small business management and performance measurement. His recent efforts have been focused on the role of management tools in shaping business strategy and promoting (or preventing) innovation. He enjoys consulting and teaching at executive level within the above areas.

Shan Zhou is a lecturer at the University of Sydney who specialises in teaching in auditing and assurance services. Shan's major area of research is on the reporting and assurance of IR, sustainability reporting and carbon emissions disclosures and she has published her research in leading academic journals.

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1

Integrated Reporting: The IIRC Framework

Chiara Mio

Abstract The International Integrated Reporting Council (IIRC) Framework is arguably the most important guide for companies willing to implement Integrated Reporting (IR). This chapter offers a review and discussion of the most important guiding principles and content elements that are the backbone of the IIRC Framework. It also compares the Framework with the main sustainability reporting standard, the Global Reporting Initiative (GRI) Guidelines. Following such a comparison, we argue that IR can be seen as an evolution of financial reporting rather than as sustainability reporting. Finally, the chapter discusses some of the most critical aspects of the IIRC Framework, such as its approach towards materiality and capitals.

C. Mio (✉)

Department of Management, Ca' Foscari University of Venice, Venice, Italy

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Introduction

The International Integrated Reporting Council (IIRC) was formed in 2010 and it contributed significantly to the development and advancement of Integrated Reporting (IR). Before 2010, some innovative reporting organizations had individually pioneered such practices (for instance, Novo Nordisk in Denmark) and in South Africa the King commission on corporate governance fostered IR, which is now a listing requirement.

This chapter provides a comprehensive overview of the IIRC Framework, published in its final version in late 2013. It focuses in particular on the most relevant guiding principles and content elements, and on their current and prospective role in IR development. It also reorganizes such content elements and guiding principles following an IR implementation perspective. The chapter also compares the IIRC Framework with the GRI Guidelines, highlighting similarities and differences.

The process that ultimately led to the current version of the IIRC Framework started in September 2011, with the issuance of the first IIRC publication: the Discussion Paper. The paper presented the rationale for IR, offering initial proposals for the development of the Framework. The next month, the IIRC Pilot Program was launched and this represented an important step towards IR, as the pilot program companies provided useful indications on how the Framework would have to develop. In June 2012, the IIRC published the summary of the responses to the Discussion Paper, and the following month the draft outline of the Framework. Later on, in November 2012, the IIRC released the Prototype of the International IR Framework, which marked a significant further step towards the eventual publication of the Framework in 2013. Between March and July 2013, the background papers were released. Such papers dealt with specific issues of the IR Framework and in particular: how organizations articulate their business model; how they use or affect the six forms of capital; how they apply the concept of materiality; how they communicate the value creation process; and how the connectivity of information must present a holistic view of an organization's strategy, governance, performance and prospects.

In April 2013, a Consultation Draft of the Framework was released, which led to the publication of responses to the draft and, eventually to the publication of the current version of the IIRC Framework on the 9th of December 2013. The Framework establishes guiding principles for organizations adopting IR, helping to ensure consistency across sectors and national boundaries. It also explains the key content elements that might be expected of an integrated report, and the fundamental concepts that underpin them. The Framework was released alongside two documents—the Basis for Conclusions and the Summary of Significant Issues—to provide further explanations about the development of the final version of the Framework.

The IIRC Framework has been attracting a great deal of attention not only among practitioners but also among scholars. In a recent article, Flower criticizes the current version of the Framework because (among other things) IR “is not to cover in a comprehensive fashion the impact of the firm’s activity on stakeholders” (see Flower 2015, p. 15), rather, it gives priority to serving the information needs of the providers of financial capital.

The author refers to one of the most important and controversial IIRC Principles: materiality, which we discuss below. Paragraph 3.11 of the Framework states that “it does not mean that an integrated report should attempt to satisfy the information needs of all stakeholders” (IIRC 2013a) and, in defining materiality, the IIRC states: “a matter is material if it is of such relevance and importance that it could substantively influence the assessments of providers of financial capital with regard to the organization’s ability to create value over the short, medium and long term” (IIRC 2013b).

We believe that the IIRC approach should not be judged from a “static” perspective but from a “dynamic” one.

Following the static perspective, companies, in order to define material issues, consider whether each issue impacts on the assessment of providers of financial capital. If the company believes that a certain issue is not going to have any effect on such assessment, it will exclude the issue from the IR. This would in turn damage those stakeholders having an interest connected to the issue that has been excluded, because they

would not be able to rely on any information provided by the company. The static perspective does not go further and does not consider possible subsequent actions by stakeholders and the relative responses of companies. Most scholars (including Flower 2015) seem to rely on this perspective, which is ultimately only connected to the assessment of providers of financial capital.

Conversely, the dynamic perspective also takes into consideration the subsequent possible actions of stakeholders and of the company. Stakeholders believing that the company should not have excluded a certain issue from the IR can actively intervene in order to make their voice heard. This requires stakeholders being “active” in the engagement process and taking responsibility. For instance, stakeholders may question companies about the exclusion or organize web or social media campaigns. The company will then have to decide how to deal with the opinion of stakeholders, through stakeholder engagement and dialogue.

After having considered the instances of stakeholders, the company may decide to amend its decision, including the issue on the IR. Alternatively, the stakeholders’ attitude may directly impact the assessment of providers of financial capital on the issue (for instance, in the case of an exclusion of an issue relevant to customers and subsequent boycott threats). Lastly, the company may confirm its decision of excluding the issue. In any case, the dialogue following the stakeholders’ stance is fundamental to the process of reaching true integration and prioritization and is made possible by the IIRC Framework approach to materiality.

We believe that the IIRC approach should be evaluated from a dynamic perspective, which is the only perspective that makes it possible to capture the opinion of stakeholders and start a dialogue. When evaluated from this perspective, the IIRC approach appears to be a necessary first step toward the real integration of information on the six capitals, through interaction between companies and stakeholders.

The IIRC chose to give priority to the providers of financial capital, but this is clearly only one of the possibilities. Other possible priorities may be explored, but they should always be evaluated under the dynamic perspective we defined above.

IIRC Guiding Principles and Content Elements

The IIRC Framework is based on the Guiding Principles and on the Content Elements, which are the backbones of IR and mirror all its main innovative aspects:

- 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”, IIRC (2013a));
- 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”, IIRC (2013a));
- 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”, IIRC (2013a));
- 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”, IIRC (2013a));
- conciseness;
- reliability and completeness (“An integrated report should include all material matters, both positive and negative, in a balanced way and without material error”, IIRC (2013a));
- consistency and comparability (“The information in an integrated report should be presented: (i) on a basis that is consistent over time; (ii) in a way that enables comparison with other organizations to the extent it is material to the organization’s own ability to create value over time”, IIRC (2013a));
- organizational overview and external environment (“An integrated report should answer the question: What does the organization do and what are the circumstances under which it operates?”, IIRC (2013a));

- governance (“An integrated report should answer the question: How does the organization’s governance structure support its ability to create value in the short, medium and long term?”, IIRC (2013a));
- business model (“An integrated report should answer the question: What is the organization’s business model?”, IIRC (2013a));
- risks and opportunities (“An integrated report should answer the 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?”, IIRC (2013a));
- strategy and resource allocation (“An integrated report should answer the question: Where does the organization want to go and how does it intend to get there?”, IIRC (2013a));
- performance (“An integrated report should answer the 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?”, IIRC (2013a));
- outlook (“An integrated report should answer the 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 and future performance?”, IIRC (2013a));
- basis of preparation and presentation (“An integrated report should answer the question: How does the organization determine what matters to include in the integrated report and how are such matters quantified or evaluated?”, IIRC (2013a)).

Hereafter, we will provide a comment on the four guiding principles and content elements that we believe to be the most relevant, as they are the most innovative compared to traditional financial and non-financial disclosure: business model, strategic focus and future orientation, connectivity and materiality.

Business model, strategic focus and future orientation are tightly connected to each other and they are the means through which IR introduces future performance, which is a “revolutionary” perspective

compared to that of annual reports. Traditional financial disclosure is almost exclusively focused on past performance, with little possibility to predict the future ability to create value in the long run. Information on future performance in traditional financial disclosure is scant and limited to a section included in the management commentary. In this section, managers often tend to provide the minimum amount of information on the evolution of the macroeconomic scenario in order to comply with regulations. Conversely, IR aims at providing relevant information on the future performance of the company. In this perspective, the business model is central, because the future performance of the organization depends to a large extent on the business model and on its interrelations with the ever-changing external environment.

Connectivity and materiality are also two very innovative principles within IR, compared to traditional financial and non-financial disclosure. In particular, connectivity reflects the integrated (as opposed to the silo) thinking approach. According to the 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” (IIRC 2013a, p. 2). Materiality plays a central role in IR because it is necessary in order to reach conciseness. The IIRC Framework proposes a four-step approach in which investors and providers of financial capital play a central role. This approach is very different compared to that of sustainability reporting and has been criticized by some for this reason (see Flower 2015).

As we already argued above, the strategic focus and future orientation principle captures one of the main benefits IR aims at introducing in the corporate reporting arena, i.e. the ability of providing future oriented information. This aspect is fundamental from an external reporting perspective, but it is also of paramount importance internally. An effective management, in fact, should pay a great deal of attention to the future evolution of the external environment and to future performances. Thus, the approach proposed by the IIRC may also be useful to companies, helping them to prevent management from focusing on the short term, which has proven to be one of the main problems in the current business environment (see Brochet et al. 2014).

According to PWC (2012), “defining the business model in the context of integrated reporting means considering all the relevant capitals on which performance depends, and explaining their role in how the company seeks to create and sustain value” (PWC 2012, p. 11). A clear definition of the business model is fundamental in communicating externally how the company produces value. At the same time, it forces companies to review their own business model, potentially allowing for relevant “internal” benefits. To summarize the business model of the organization, possibly in the form of a chart or graph, allows one to communicate the model within the company, resulting in great potential benefits for employee morale and motivation. Often, not all the employees working in an organization have an overall idea of how the company is producing value. This may be an issue, both in terms of motivation and of the ability of employees to make decisions and to effectively communicate the values of the company.

Such information about the business model is also particularly relevant to current and potential investors, who are much more interested in understanding how the company actually works rather than in knowing about its more formal or “bureaucratic” aspects. According to KPMG, “the journey to Better Business Reporting, culminating in an Integrated Report prepared under the IIRC’s Integrated Reporting Framework, should be of particular interest to CEOs, CFOs and directors as they face the challenge of convincingly telling their organization’s ‘story’ to the markets so they can obtain capital at a reasonable cost” (KPMG 2011, p. 7).

Connectivity of information (which is tightly linked to integrated thinking, as opposed to silo thinking) and materiality are two of the most challenging principles proposed by the IIRC. These are the two principles that companies usually find more challenging to implement and really require a strong commitment by top management. To decide what the material issues are and how the different forms of capital combine are challenging tasks that need a great amount of judgment. It is interesting to notice that the four elements we identified as the most innovative (strategic focus, business model, materiality and connectivity) are closely related to each other: in order to understand material issues, companies necessarily need to take into account their business model and the future evolution of external and internal environments. Once materiality is

determined, connectivity shows the interrelationships between material issues and how they impact on future performance, conditional on the business model.

Such principles are also central in the definition of the two IIRC Framework mechanisms that may shape an organization's decision about sustainability disclosure (and investments): the market and the voice of stakeholders.

Another one of the main innovations introduced by IR is the shift in the identification of the main object of study. In other words, while Sustainability Reporting (and in particular the GRI Guidelines) focuses on the subject (the stakeholders), IR focuses on the object (the capitals). The capitals store value that's needed by organizations to create sustainable profit and prosperity for society. These values can be transformed, increased or decreased through the activities and outputs of the organization (EY 2014).

The latter is a striking difference that strengthens the diversity between IR and sustainability reporting, suggesting that IR is an evolution of financial rather than sustainability reporting. Such a difference in approach is even more pronounced if we consider that it is not possible to identify a 1 to 1 relationship between capitals and stakeholders. The same stakeholder has an impact on different capitals, and IR requires organizations to focus on the latter. Stakeholders maintain a fundamental role in IR, because the concept of capitals itself derives from the consideration that the organization deals with different subjects, each of which influence and are influenced by the organization. Nevertheless the concept of stakeholder in IR, when compared to Sustainability Reporting, is much less prominent. This diminished importance is clear if we examine the definition of materiality, which requires companies to assess the relevance of the issues to the providers of financial capital, rather than to the wider array of stakeholders.

It is interesting to compare the stakeholder and the capital approach under the perspective of the current evolution of society. As Bauman (2000) noted, we live a "liquid modernity", in which a person can shift from a position to another in a fluid manner. The same person can simultaneously be the customer, employee and shareholder of the same company. He may even be a member of the community where the company

operates (as a matter of fact, this is a likely occurrence). In such a context, stakeholder-based classifications become less relevant, because the boundaries between different stakeholder categories are less relevant. On the contrary, the capital approach seems to be more appropriate, because it captures the ultimate impacts of the different stakeholders (independently from their categories) on capitals, which are the relevant objects of analysis for companies.

Interestingly, the IIRC capital approach has been linked to business resilience (see IFAC 2014). Putting the focus on capital reinforces the concept that businesses are part of a larger, interconnected system and this promotes a wider perspective that allows the company to understand dependencies and impacts. According to IFAC (2014) “This understanding can lead to the development of a more resilient business model that is the basis for creating and sustaining value over time”.

One of the main factors that will probably determine the success of IR in the future is the actual possibility of measuring the stocks and flows of capital. In other words, KPIs are going to play a central role, even if the IIRC Framework does not list any specific indicators. Some guidance may be found in other documents published by the IIRC (see IIRC 2013c) and by the German Association for Financial Analysis and Asset Management, together with the European Federation of Financial Analysts Societies (EFFAS 2011), that jointly published a paper including an extensive list of KPIs for each of the 114 subsectors presented.

Academic researchers will have to play a significant role in this field. It is commonly recognized that the general idea underlying IR holds, but what is going to determine the actual ability of the Framework to spread around the world is the possibility of finding adequate measures for capitals. Such measures do not need to be excessively “deterministic”, but academics, policy makers and companies must accept the fact that measuring the IR capitals is a challenging task that necessarily requires judgment, forecasts and approximations. Even traditional financial accounting relies to a large extent on appraisals (for instance, provisions) that often have a significant impact on the bottom line. Probably, the perception of such appraisals is weaker in annual reports, because everything is ultimately measured in financial terms.

Guiding Principles and Content Elements: An IR Implementation Perspective

In this paragraph, we are re-organizing the IIRC Framework Guiding Principles and Content Elements and classifying them from an IR implementation perspective. In other words, we are identifying the main IIRC principles that an organization creating its IR ought to consider and we are linking them to specific phases of IR implementation (Fig. 1.1).

Companies employ the first set of principles in order to identify the potential information to be considered for analysis. In this respect, the organization ought to consider the strategic focus and future orientation and the Stakeholder relationship principles. Despite the organization still being in the first potential information selection phase, the stakeholder relationship principle already requires some judgment in order to identify relevant stakeholders. In fact, unlike GRI Guidelines and other forms of sustainability reporting, the IIRC focuses on the whole performance of the company, and not merely on sustainability performance.

Since one of the main features of IR is conciseness, it is of paramount importance for the company to select information that is material,

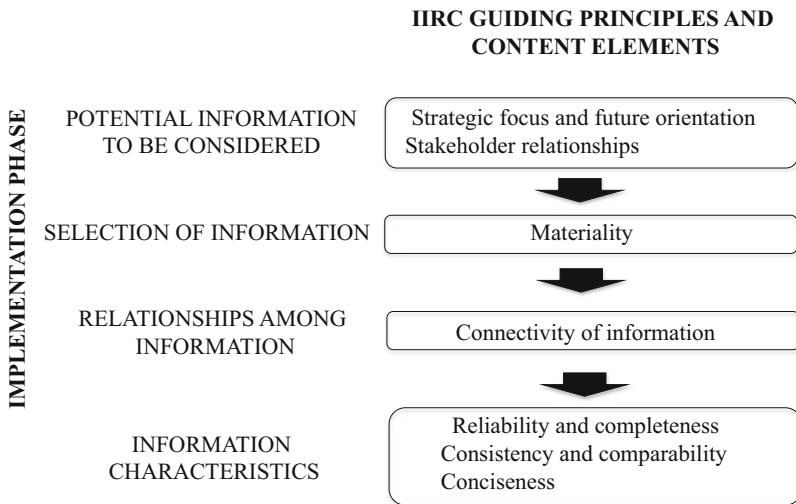


Fig. 1.1 Implementation phases and IIRC guiding principles

through the materiality principle. The IIRC (2013a) argues that “a matter is material if it is of such relevance and significance that it could substantively influence the assessments and decisions of the organization’s highest governing body, or change the assessments and decisions of intended users with regard to the organization’s ability to create value over time.” Since this principle is probably one of the most challenging and requires much judgment, the IIRC issued a specific document, providing information on how to identify material issues (IIRC 2013a).

Once the information has been selected, the company needs to connect it in a proper way, therefore implementing the connectivity principle. To communicate the performance of the company in a really connected (integrated) way requires a deep understanding of the business model and strategy. Finally, the organization needs to consider the Reliability and completeness, Consistency and comparability and Conciseness principles, which are needed in order to present the information.

GRI Guidelines and IIRC Framework: A Comparison

This paragraph aims at comparing the GRI Guidelines and the IIRC Framework along some of their main principles. Comparing the IIRC Framework with the main, non-financial reporting framework is relevant in order to highlight the differences arising between the two and to understand the underlying IR “philosophy”. In this respect, it is possible to see that the IIRC Framework shares relevant similarities with financial reporting rather than with sustainability reporting (for instance, in the definition of materiality). We therefore consider IR to be an evolution of financial annual reports rather than of sustainability reports.

Stakeholder Relationships

The key difference in the definition of the stakeholder relations lies in the identification of the report recipients. According to the GRI, companies need to identify stakeholders (and their “reasonable expectations and

Table 1.1 GRI and IIRC (stakeholder relationships)

GRI	IIRC
<p><i>Stakeholder inclusiveness principle</i></p> <p>The organization should identify its stakeholders, and explain how it has responded to their reasonable expectations and interests</p>	<p><i>Stakeholder relationships</i></p> <p>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</p>

interests”) who will probably employ the report in their decision making process. The reporting entity must therefore determine the level of detail of the information that is useful to the stakeholders and consider their expectations. The IIRC, on the other hand, requires companies to focus on the stakeholders that the company believes to be fundamental in the value creation process, thus resulting in a more narrow selection of stakeholders compared to the GRI (Table 1.1).

Materiality

According to the GRI, materiality is a threshold that makes an issue sufficiently important for the organization to report on it. The threshold should consider both the magnitude of the impact (economic, social and environmental) connected to the issue and the relevance of the issue to the stakeholders. Clearly, the identification of the threshold for non-financial matters is more challenging compared to financial ones. In order to define the relevance of the impact of a certain issue on financial performance one may simply consider a threshold that is determined as a percentage of revenues. But how can one define the relevance of an issue having a non-financial impact? Given that not everything is traded in an active market, this task may turn out to be quite challenging (Table 1.2).

The IIRC identifies as material those issues that have a significant impact on the ability of the organization to create value. In other words, the company ought to consider the potential impacts of such issues

Table 1.2 GRI and IIRC (materiality)

GRI	IIRC
<p><i>Materiality principle</i></p> <p>The report should cover aspects that:</p> <ul style="list-style-type: none"> Reflect the organization's significant economic, environmental, and social impacts; or Substantively influence the assessments and decisions of stakeholders 	<p><i>Materiality</i></p> <p>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</p>

on strategy, governance, performance and future outlook. As the IIRC focuses on long-term value creation, such material issues are often the same issues that are tackled by the most important governing bodies of the organization.

The main differences between GRI and IIRC, therefore, are: the parameters for the definition of materiality (social and environmental aspects for the GRI and value creation for the IIRC) and the subjects to be considered in this process (main stakeholders for the GRI and providers of financial capital for the IIRC).

Comparability

The GRI focuses on stakeholders and should be able to analyse changes in the organizational performance over time. Conversely, the IIRC refers (once again) to the value creation process, in the sense that information should be presented in a way that enables comparison with other organizations to the extent that it is material to the organization's ability to create value (Table 1.3).

The perspectives of the two frameworks are therefore different: they range from focusing on stakeholders (GRI) to focusing on the reporting entity itself (the IIRC).

Table 1.3 GRI and IIRC (comparability)

GRI	IIRC
<p><i>Comparability principle</i></p> <p>The organization should select, compile, and report information consistently. The reported information should be presented in a manner that enables stakeholders to analyze changes in the organization's performance over time, and that could support analysis relative to other organizations</p>	<p><i>Consistency and comparability</i></p> <p>The information in an integrated report should be presented:</p> <ul style="list-style-type: none"> On a basis that is consistent over time In a way that enables comparison with other organizations to the extent it is material to the organization's own ability to create value over time

Connectivity of Information

The GRI Guidelines are inspired by sustainability, therefore they require the report to present the performance of the organization in the wider context of sustainability. Conversely, the IIRC introduces the concept of “connectivity of information”, that requires information to be inter-related both in terms of content and time frame. In other words, IR aims to extend beyond the boundaries of non-financial and sustainability disclosure and to make a closer connection with financial performance (Table 1.4).

Reliability and Conciseness

While the GRI employs four different principles connected to the reliability and completeness principle (completeness, accuracy, balance and reliability), the IIRC manages to synthesize all these aspects in the Reliability and completeness principle (Table 1.5).

Table 1.4 GRI and IIRC (connectivity of information)

GRI	IIRC
<i>Sustainability context</i>	<i>Connectivity of information</i>
Principle	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
The report should present the organization's performance in the wider context of sustainability	

Table 1.5 GRI and IIRC (reliability and conciseness)

GRI	IIRC
<i>Completeness principle</i>	<i>Reliability and completeness</i>
The report should include coverage of material Aspects and their Boundaries, sufficient to reflect significant economic, environmental and social impacts, and to enable stakeholders to assess the organization's performance in the reporting period	An integrated report should include all material matters, both positive and negative, in a balanced way and without material error
<i>Accuracy principle</i>	
The reported information should be sufficiently accurate and detailed for stakeholders to assess the organization's performance	
<i>Balance principle</i>	
The report should reflect positive and negative aspects of the organization's performance to enable a reasoned assessment of overall performance	
<i>Reliability principle</i>	
The organization should gather, record, compile, analyze and disclose information and processes used in the preparation of a report in a way that they can be subject to examination and that establishes the quality and materiality of the information	

Conclusions

This chapter offers a review of the IIRC Framework, and in particular of the guiding principles and content elements, which are the backbone of such a framework. In particular, we focused on the most important elements of the framework: business model, strategic focus and future orientation, connectivity of information and materiality. They contain some of the most important and innovative features of IR, compared to traditional financial and non-financial disclosure. Besides this, they are closely related to each other, as materiality determination requires companies to take into account their business model and the future evolution of external and internal environments. Connectivity shows the interrelationships between material issues and how they impact on future performance, conditional on the business model.

We compare the stakeholder approach, which is typical of sustainability reporting, with the IR capital approach and we argue that the latter is more in line with the liquid society in which we are living. In current society, the same person can simultaneously be the customer, employee and shareholder of the same company and, in such a context, the stakeholder-based classifications become less relevant. On the other hand, the capital approach captures the ultimate impacts of the various stakeholders (independently from their categories) on capitals, which are the relevant objects of analysis for companies.

Capital measurability will probably play a central role in the future diffusion of IR practice. On the one hand, academic researchers will have to play a key role in the advancement of this issue. On the other hand, IR users need to accept the idea that appraisals are necessary and play a central role in traditional financial reporting as well.

We also compare the IIRC Framework with the GRI Guidelines, highlighting similarities and differences along the following dimensions: stakeholder relationship, materiality, comparability, connectivity of information and reliability and completeness. Such analysis allows us to conclude that IR is more closely linked to financial than to sustainability reporting and should therefore be considered as an evolution of the former.

Finally, we posit that the IIRC approach to materiality should not be judged from a “static” but from a “dynamic” perspective. The dynamic

perspective also takes into consideration the stakeholder's voice and dialogue, both of which are necessary to reach true integration and prioritization. When evaluated from such a perspective, the IIRC approach appears to be a necessary first step toward real integration of information on the six capitals, through interaction between companies and stakeholders.

The IIRC chose to give priority to the providers of financial capital, but this is clearly only one of the possibilities. Other possible priorities may be explored, but they should always be evaluated under the dynamic perspective defined above.

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2

Strategy and Business Model in Integrated Reporting

Marco Vedovato

Abstract The International Integrated Reporting Framework suggests the inclusion of a description of an organization strategy and business model in public integrated reporting. An organization's strategy and business model lies at the heart of its capacity to create and sustain value over time. However, reporting on these issues is far from a mature practice and companies lack previous experience as well as established models to guide them. This chapter examines the current practice of reporting on strategy and business models. We draw on the guidelines for strategy and business model reporting proposed by the International Integrated Reporting Council, as well as relevant literature on strategy and business models, to discuss four recent reports illustrative of the guiding principles.

M. Vedovato (✉)

Department of Management, Ca' Foscari University of Venice, Venice, Italy

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Introduction

One of the primary purposes of integrated reporting (IR) is to explain to investors and other stakeholders how an organization creates and sustains value over time. According to the International IR Framework of the International Integrated Reporting Council (IIRC 2013a, p. 7), 'an integrated report is 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'.

Given the purpose of IR, it is fair to state that a description of an organization's strategy and business model is of paramount importance. Value creation lies at the very core of the concept of strategy. In fact, one of the possible definitions of strategy is how an organization intends to create value for its stakeholders. Strategy links environmental and internal variables to a set of objectives and identifies the main courses of action through which such objectives should be pursued. Therefore, a clear and exhaustive description of the strategy is necessary in any report aiming to inform on value creation perspectives.

A business model is a related but distinct concept. It can be described as the essential rationale of an organization's functioning and, although there is no general consensus on the point, it is often portrayed as a concept complementary to strategy, providing insight into the logic of strategy actuation. The account of a business model encompasses the identification of all the elements relevant to the business functioning and their interrelations. For instance, Osterwalder and Pigneur (2010), in what is arguably the most popular template for the description of a business model, identified nine 'building blocks': key partners, activities and resources, value proposition, customers, channels and customer relationships, cost structures, and revenue streams.

Despite the informative relevance of these concepts, their presence in public reporting has traditionally been limited. Eccles et al. (2015, p. 191) analyzed 124 companies' self-declared integrated reports prepared before the publication of the International IR Framework. Even in this plausibly very 'advanced' set of companies, the reporting quality on the strategy and business model was not entirely satisfactory: On the one

hand, the two concepts were evaluated fairly well as reported by 78 % of companies; on the other hand, serious concerns emerged. For instance, the authors were not able to find a single case in which the company explicitly defined the relations between its business model and value creation. Strategy was one of the most diffuse content elements, since it rarely appeared in a well-defined section but was typically covered in discussions about other issues.

The problem is that, although strategy and business model reporting is currently considered fundamental, it is far from a mature practice and companies lack previous experience as well as established models to guide their reports (Page 2014). The International IR Framework aims to improve this situation by providing a reference for making strategy and business model reporting more consistent across organizations and connect more with other reporting elements.

This chapter aims to discuss the current practice of reporting on strategy and the business model in light of the International IR Framework and its first applications. We first briefly outline the guidelines for strategy and business model reporting proposed by the IIRC. We then discuss the relevant literature on strategy and business models. Finally we examine four reports selected by the IIRC Secretariat as illustrative of the guiding principles. Concluding remarks follow.

Strategy and Business Model Reporting in the International IR Framework

Strategy, Strategic Objectives and Strategic Focus in IR

Strategy is a recurring term in the International IR Framework, both as content to be included in the report (strategy) and as a principle guiding the preparation of the entire report (strategic focus). More specifically, strategy is first mentioned as content in the definition of an integrated report: ‘An integrated report is 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 2013a, p. 7).

Strategic focus, combined with future orientation, moreover, is the first of the guiding principles that should underpin the preparation and presentation of an integrated report: ‘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’ (IIRC 2013a, p. 16). The Framework, opportunely, makes it clear that application of this principle is not limited to the part of the report specifically describing strategy but should also inform the selection and presentation of other content.

Finally, strategy is one of the eight content elements to be included in an integrated report: ‘An integrated report should answer the question: Where does the organization want to go and how does it intend to get there?’ (IIRC 2013a, p. 27). To answer this question, the integrated report should identify the organization’s strategic objectives, the strategies it has in place or intends to implement to achieve such objectives, its resource allocation plans to implement the strategy, and how it will measure achievements and target outcomes.

In sum, strategy is relevant to IR as follows:

- The integrated report should have a strategic focus and
- The integrated report should include a description of the organization’s strategy.

The IIRC (2013a, p. 5) defined strategic focus as providing ‘insight into the organization’s strategy’ and strategy as ‘strategic objectives together with the strategies to achieve them’ (IIRC 2013a, p. 33). Therefore, it is possible to deduce that, according to the IIRC:

- Strategy is intended as a plan. To inform about strategy means informing about plans and tactics that the organization intends to use to achieve its aims (strategic objectives).
- Strategic objectives are very important objectives that must be accomplished on the way to reaching the ultimate objective, which is value creation.
- Strategic focus means that the report, in all its parts, should provide ‘strategically important’ information, that is, that is important to understanding the prospects of value creation.

The Business Model in IR

The International IR Framework places the business model at the core of an organization's value creation process. According to the Framework, an organization's business model is 'the system of transforming inputs through its business activities into outputs and outcomes that aims to fulfill the organization's strategic purposes and create value over the short, medium and long term' (IIRC 2013a, p. 25). An integrated report, therefore, should describe the four components of the business model: inputs, business activities, outputs, and outcomes.

Inputs are the various capitals on which the organization depends or that provide a source of differentiation. The capitals are the resources and relationships used by the organization and are increased, decreased, or transformed as a consequence of its activities and outputs. The framework identifies six categories of capital: financial capital, manufactured capital, intellectual capital, human capital, social and relationship capital, and natural capital. Any organization uses many inputs but only those relevant to the ability to create value should be reported, whether or not they are owned by the organization. In fact, only some of the capitals that the organization uses and affects belong to the organization. Others may greatly influence the business model without being owned or even bearing a cost. As an example, consider the view and natural environment of a resort, advancements in processor technology for a high-tech company, or the availability of specific raw materials for an organization that relies on them. As long as the capitals are necessary or constitute a source of differentiation and are ultimately capable of influencing the value creation potential, they should be reported, to demonstrate the robustness and resilience of the business model.

The inputs are transformed into outputs by business activities. The activities that contribute to the organization's differentiation and value creation should be included in the report. Depending on the business model's characteristics, relevant activities can include, for instance, research and development, innovation management, employees training and relationship management, as well as more 'direct' activities, such as manufacturing, marketing, and after-sales services.

Outputs are the organization's key products and services and are typically the source of revenues. The Framework is not explicit on this point

but, to express the output's relevance for the business model, a mere description of the organization's offerings is probably insufficient. On the contrary, the report could highlight the customer segment the organization wants to serve and how the outputs respond to customers' needs.

The organization's activities and outputs lead to outcomes in terms of effects on its capitals. The outcomes can be internal (e.g. employee development, plant efficiency, product quality, revenues) or external (e.g. tax payments, job creation, knowledge spillover) and positive, if they result in a net increase in the capitals, or negative, if they diminish capital value. The explanation of an organization's impacts on capitals allows the appreciation of the sustainability of its business model over time, since the change produced on capital stocks can influence their availability as inputs in the future.

The International IR Framework also suggests practical solutions for reporting on the business model (IIRC 2013a, p. 25). First, the key business model elements should be explicitly identified. This is to contrast the limitations that follow from using generic language and discussing business model elements without formally labeling them (IIRC 2013b, p. 4). Moreover, the Framework suggests including a simple diagram of the business model together with a clear explanation of the relevance of the elements to the organization. A narrative addressing important issues is also recommended. Finally, the Framework recommends that the business model identify stakeholders and any external dependency and explicitly trace connections with information covered in other parts of the report, such as those dedicated to strategy and performance.

Strategy

Any book or manual on strategy and strategic management devotes a good number of its pages to defining what strategy is. An exhaustive examination of the different approaches and definitions is certainly beyond the scope of this chapter, but accounting for the complexity of the debate on strategy is useful, since one should be aware of what strategy is before facing the endeavor of describing it for the benefit of an external reader.

Fifty years ago, Chandler (1962) defined strategy as the determination of an enterprise's long-run objectives, the adoption of courses of action,

and the allocation of the resources necessary to carry out these goals. The emphasis on the determination of goals and the allocation of the resources necessary to attain the goals marks the similarity of this definition with that provided by the International IR Framework (IIRC 2013a; see also above).

According to Porter (1996), competitive strategy is about being different. It means deliberately choosing a different set of activities to deliver a unique mix of values. Porter's definition focuses on deliberate choices, differentiation, and, especially, the activities performed. Choosing to perform activities differently from rivals enables the acquisition of a competitive advantage and prevents imitation. The emphasis on activities as a source of sustainable advantage recalls the role attributed to activities in some definitions of the business model, including that provided by the IIRC (2013a).

Mintzberg (1987) described five ways of looking at strategy: as plan, ploy, pattern, position, and perspective. If the term plan recalls Chandler's definition and ploy and position are elements of Porter's definition, the other two terms provide new perspectives. Strategies are a 'pattern' in a stream of actions, since they do not always follow a deliberately chosen and logical plan but can emerge. Strategy is therefore a consistent behavior, whether intended or not. In addition, according to Mintzberg, strategy is also a perspective, an ingrained way of perceiving the world. The choices an organization makes about its strategy rely heavily on its culture. Just as patterns of behavior can emerge as strategy, patterns of thinking will shape an organization's perspective and actions.

Finally, Johnson et al. (2013) defined strategy as an organization's long-term direction. This concise definition can include both deliberate strategy and emergent patterns of behavior. Moreover, it suits both strategies that strive to outperform rivals and more cooperative strategies.

Business Model

The business model has emerged as a central concept in recent management debate. Many scholars have provided definitions of the business model (for a review, see Zott et al. 2011) and discussed its relationship

with strategy (Zott and Amit 2008; Teece 2010). Despite the considerable variation in business model definitions, the development of the debate can be summarized along three dimensions:

- What is a business model? What is its function?
- What are the business model's components?
- How does a business model relate with strategy?

What Is a Business Model? What Is Its Function?

According to Teece (2010), a business model embodies the organizational and financial architecture of a business. Similarly, Casadesus-Masanell and Ricart (2010) defined a business model as the logic of a firm, the way it operates, and how it creates value for its stakeholders. Other definitions include 'stories that explain how enterprises work' (Magretta 2002), 'heuristic logic that connects technical potential with the realization of economic value' (Chesbrough and Rosenbloom 2002), and 'a system of interdependent activities' (Zott and Amit 2010).

As observed by Morris et al. (2005), one main difference among definitions lies in the terms used to refer to the concept of the business model: architecture, logic, story, and system. Another element of differentiation is the emphasis placed on value creation and success and, more generally, on the final outcome identified. While some definitions more or less explicitly refer to the aim of 'making money', others refer to more general objectives. However, whatever the terms used to express the business model's function and the expected results, the definitions converge in stating that a business model explains the functioning of the organization and how it facilitates the attainment of the selected objectives.

What Are the Business Model's Components?

A good degree of variation also exists in the list of a business model's components. Johnson et al. (2008) held that business models consist of four interlocking elements: customer value proposition, profit formula, key

resources, and key processes. Osterwalder and Pigneur (2010) identified nine building blocks: key partners, activities and resources, value proposition, customers, channels and customer relationships, cost structures and revenue streams.

Chesbrough and Rosenbloom (2002) suggested that a business model fulfills seven distinct functions, including (1) articulating the value proposition, (2) identifying a market segment, (3) defining the structure of the value chain required to create and distribute the offering, (4) detailing the revenue mechanism(s) by which the firm will be paid for the offering, (5) estimating the cost structure and profit potential, (6) describing the position of the firm within the value network linking suppliers and customers, and (7) formulating the competitive strategy by which the firm will gain and hold an advantage over rivals.

Morris et al. (2005) suggested that a business model is characterized by six components: How do we create value? Who do we create value for? What is our source of competence? How do we competitively position ourselves? How do we make money? What are our time, scope, and size ambitions?

How a Business Model Relates with Strategy?

As mentioned, according to Chesbrough and Rosenbloom (2002), competitive strategy is a component of the business model. In addition, the scheme proposed by Morris et al. (2005) includes variables that are commonly related to strategy. Other scholars disagreed on the issue, considering strategy a distinct but related concept. On this point, Casadesus-Masanell and Ricart (2010) provided one of the most straightforward discussions on the relationship between strategy and the business model:

- The business model refers to the logic of the firm, the way it operates, and how it creates value for its stakeholders.
- Strategy refers to the choice of business model through which the firm will compete in the marketplace.

Strategy builds on the perceived opportunities and risks arising from the environment and on the perceived qualities of the internal structure to determine appropriate objectives and suitable courses of action (e.g. products and services). The business model's role, then, is to deliver this strategy and consequently accomplish the desired objectives. Evaluating the current business model against the strategy could suggest that changes to the business model are necessary to implement the chosen strategy. At the same time, the current business model influences what Mintzberg (1987) called perspective and therefore influences organization members' perception of the environment and the organization, thus contributing to the shaping of strategy.

Examples

The IIRC promoted a database of examples of integrated reports. The database allows for the selection of available reports using several criteria, including the year of publication, the region and sector of the organization, and the strengths of the report as evaluated by the IIRC Secretariat. The strengths are evaluated focusing on the alignment of the report with the content elements, fundamental concepts, and guiding principles included in the International IR Framework. Therefore, it is possible to select the reports that, according to the IIRC, best comply with the International IR Framework.

To identify the reports to be reviewed, the following criteria were used:

- The report was from the year 2014,
- The report was selected by the IIRC to illustrate the guiding principle of 'strategic focus and future orientation', and
- The report was selected by the IIRC to illustrate the content elements of 'strategy and resource allocation' or the 'business model'.

Application of these criteria led to the identification of four reports, one for the content element of strategy and resource allocation and three for the business model.

British American Tobacco

British American Tobacco (BAT) was selected as illustrative of the IR content element strategy and resource allocation. The report is composed of 222 pages, including 14 dedicated to strategic management. Another nine pages are dedicated to the business environment and are therefore relevant to the strategy discussion.

The strategic management section states the company vision, mission, and guiding principles. Four main areas of strategic focus are then identified: growth, productivity, a winning organization, and sustainability. For each area, the report provides an explanatory narrative and a set of key performance indicators (KPIs). The narrative is mainly dedicated to describing the results achieved but also includes occasional parts explaining the area's strategic relevance, describing actual practices, or identifying objectives for the future. The strategic management section also includes two pages dedicated to describing the business model. Interestingly, these two pages were not included in the extract selected by IIRC. The business model is defined as the way the company uses its strengths, resources, and relationships to deliver value to shareholders and stakeholders following the strategy. The business model is described by means of a diagram that places customers at the center and the main processes (sourcing, production, and distribution) around them. For each of these four issues (sourcing, production, distribution, and the customers), the report briefly explains its strategic relevance and a summary of current endeavors.

As mentioned, the report also includes a section on the business environment. It is dedicated to delineating current trends in tobacco consumption and expectations for the future, including implications from litigation, regulations, and trafficking. A discussion of the group's main risks is also provided.

The BAT's 2014 annual report does not, overall, seem particularly influenced by the International IR Framework. There is no reference to the six capitals as either inputs or outcomes. Information on the strategic relevance of some input factors is provided (e.g. the tobacco leaves' quality, human resources) but they are dispersed throughout the strategic management section. The same is true for the effects on capitals.

A section is dedicated to sustainability, providing information on the actions in place to moderate risks for customers, prevent youth smoking, promote sustainable agriculture, and reduce emissions and energy consumption. However, the reporting style does not resemble that suggested by the International IR Framework and some divergence can be noted for the content as well. One notable difference relates to future orientation. Objectives are expressed in general terms and thus there is neither a clear identification of the strategies in place to achieve them nor an identification of resource allocation plans.

Discussing the report in light of the literature on strategy is a difficult task, since the letter was certainly not written with external reporting in mind. However, it is fair to say that the BAT report is capable of providing some understanding of the group's strategy according to both the plan and pattern perspectives. In fact, it provides a brief description of future plans (e.g. continue to provide tobacco to consumers, including the next-generation of nicotine-based products) as well as an account of the actions in place and the results achieved that provides the reader a view of the realized strategy (at least a rationalized version).

In conclusion, while the BAT report is certainly rich in information on actual activities, past performance, and risks and mitigation activities, it is hard to see how it could be seen as a reference to illustrate reporting on strategy and resource allocation under the IIRC Framework.

Eni

Eni (an Italian multinational oil and gas company) was selected by the IIRC Secretariat as illustrative of the business model content element of IR. The 107-page report encompasses two pages describing the business model, two pages illustrating strategic objectives (target and performance drivers), and two pages dedicated to strategy. Moreover, two pages are dedicated to the competitive environment and four to performance indicators. Overall, 12 pages are relevant to this chapter's analysis.

The competitive environment section includes a brief narrative highlighting major environmental trends relevant to Eni and, accordingly, identifies four main challenges (the oversupply of oil, geopolitical risks,

transformation of the energy market in Europe, and raising the awareness of risks related to climate change) and the main actions and plans for facing them. The strategy section links to the aforementioned challenges (particularly to low oil prices) and derives the main strategic objective (cash generation) and the main action plans (well-designed industrial actions, capital discipline, a focus on upstream activities, and a large disposal plan). Then, the implications for Eni's segments are made explicit. These implications are stated as objectives and business policies through bullet point lists and often resemble a detailed version of the actions and plans listed in the competitive environment section.

Moving to the business model section, here again we find—this time under the label of strategic guidelines—some of the issues mentioned in the competitive environment section (as action and plans) and in the strategy section (as action plans). However, while there is certainly overall coherence, the usage of different wording muddles the message a bit. The strategic guidelines, together with list of distinctive assets and principles, are used to graphically represent Eni's business model and the use of capitals in delivering sustainable value. The six capitals are labeled according to the International IR Framework and appear also in a table that, for each capital, identifies the resources relevant for Eni, the actions in place or planned (again coherent with but not identical to those previously mentioned), and the expected results for Eni and its stakeholders.

The targets and performance drivers section identifies four main strategic objectives: (1) increasing the value of explorative resources and growth in upstream cash generation, (2) returning to structural profitability in the gas and power business, (3) a turnaround in the 'refining and marketing' and in the 'chemical' business, and (4) a focus on efficiency. For each objective, the implications for the management of the six capitals are derived as actions taken or planned. Finally, the aforementioned four strategic objectives are used to title the panels of performance indicators. Thus, for each of Eni's four main strategic objectives, a set of indicators is presented showing the last three years' performance for each of the six capitals.

The Eni 2014 report demonstrates clear effort in adopting the International IR Framework. Reference to the six capitals is pervasive and

a section is dedicated to each content element. There are also signs of an attempt to connect the different parts of the report but usage of a variety of terms hampers the overall readability. Moreover, the connections are not made explicit (i.e. there are no cross-references) and are left to the reader to determine. The effectiveness of the report would have probably been improved by the preparation of an overall picture connecting the different parts and explicitly showing their relationships.

As for the business model description, for which Eni was selected as an illustrative case, it formally follows quite closely the International IR Framework. However the report is not particularly effective at accomplishing the main function of a business model according to the literature, namely, to express the rationale of the organization's functioning and to show how it will contribute to the attainment of strategic objectives. An example will help clarify this point. Six different issues are mentioned to describe human capital, including experience, engagement, diversity, and skills. Eni's actions toward human capital are described by eight items, including workplace safety, recruiting education and training, welfare, and knowledge management. Value creation for Eni is then described through eight rather general concepts, such as performance, efficiency, innovation, and reputation. This combination, on the one hand, provides a great deal of detail but, on the other hand, is not particularly informative about the role of human capital within the business model or the attainment of strategic goals and probably applies to almost any organization. A more concise presentation of the business model, possibly based on a standard set of components and accompanied by a coherent narrative, would have probably been more effective in convincing the reader that the business model adopted was the best possible one for pursuing the selected strategic objectives.

Iberdrola

Iberdrola is a Spanish producer of electricity active in several countries in the Atlantic area. The report was selected by the IIRC Secretariat as demonstrative of business model reporting. It includes a 15-page chapter titled 'Business Model and Strategy', with seven sections.

The first one, titled ‘The Future of Energy’, provides an outlook on long-term trends in the energy sector and depicts a future of increased electricity demand. This prediction is supported by third-party studies and by interpreting general trends, such as the transition to a low-carbon economy and increasing access to electricity. The section effectively depicts a future of growing opportunities for the Iberdrola group.

The next section is dedicated to the business model. It provides a general overview of the group’s rationale of value creation and includes several links to more comprehensive analysis within and outside the chapter. More specifically, it briefly describes the group’s long-term objectives and values, distinguishing factors, capitals used, and the main components of the value chain. Each of these content elements is accompanied by an explanatory piece. The business model section therefore provides a concise albeit extensive overview of the business model, also acting as a guide for other content in the report.

The next sections provide a more comprehensive explanation of the group’s distinguishing factors, its approach in managing the six capitals, and the main phases of the value chain. The first two sections point to other, even more detailed, parts of the document, while the third section presents figures useful in better understanding the group’s operations.

The next section is dedicated to strategy and plans for the future. The discussion moves from the implications of the scenario drafted in the first section and thus derives the challenges and opportunities for the group. The planned investments are then briefly mentioned, followed by a presentation of the ‘strategic pillars’: a balanced risk profile, operating efficiency, and financial strength. Each of these items is accompanied by a brief description of the implementation actions planned and a number of quantitative targets. The section is very effective at showing what actions are planned, why they are sensible given the environmental conditions, and what the expected results are.

Iberdrola’s approach in managing the six capitals is further explained in a separate section that provides an ample presentation of the relevant resources, past actions, and an outlook of the future. Moreover, a number of key figures are provided for each capital. The presentation in a separate section of the greater part of the information about the six capitals is

particularly rewarding in terms of clarity. Moreover, general consistency in the terminology and frequent cross-references allow for easy and informative reading.

Sage

The 2014 report of the software vendor Sage is composed of three main sections: the strategic report, the governance report, and the financial statement. The strategic report is about 60 pages long and includes a four-page part dedicated to the business model and 12 pages dedicated to strategy. The remaining part provides information about the organization's products and markets, its customers, performance, and corporate responsibility.

The document explicitly links the strategy to the business model, placing strategy 'at the heart' of the business model and as a guide in helping the organization respond to the changes taking place in the markets served.

The strategy paragraph amply discusses the technological and economic motivations of the main strategic objective, which is to move the business from selling perpetual license software to selling subscription-based products and services. Moreover, the chapter provides figures about progress made toward the transition and informs about the impact of the strategy on the main processes and on investment policies.

The business model paragraph is dedicated to explaining how the strategy is being implemented. The key elements of the business model are to attract, activate, grow and retain (customers), and describe a path that relies on important resources (such as a trusted brand, a strong partner network, product localized to account for different legislative environments, and first-class support) to transform occasional purchasers into returning customers and subscribers who use a wide range of Sage products and services for life. The business model description is complemented by key performance indicators (KPIs).

The report does not resemble in any part the model proposed by the International IR Framework but nonetheless effectively delivers a clear picture of the organization's strategic objectives and its business functioning

rationale. Moreover, the document fulfills important IR Framework recommendations, such as describing future orientation and providing connections between concepts.

Conclusions

Strategy and business model reporting is becoming more common, as a consequence of both the influence of the IR movement and reforms in national legislation, such as the reform of narrative reporting in the U.K. Corporate Governance Code. However, such reporting is far from an established and mature practice and many organizations are still facing difficulty in preparing their reports.

This chapter focused on the strategy and business model concepts and examined the guidelines for their reporting provided by the International IR Framework. Moreover, it discussed the strategy and business model sections of four reports selected by the IIRC Secretariat as representative of the topics in question.

The analysis of the four cases allows for a couple of concluding remarks. First, it showed that wide variations exist in reporting styles and content, certainly well beyond the flexibility that the IIRC explicitly leaves to organizations. Some of the cases reviewed did not follow the International IR Framework at all. This is somewhat surprising, given the inclusion criteria. It certainly does not constitute a problem per se, but it reveals that harmonization in corporate reporting is still a distant goal. Second, it points out that reporting on business models and especially strategy is incomplete in comparison to the description of the concepts provided in the literature. In fact, strategy is generally reported just as a plan and the business model description is only partial. Of course, this can be explained by the competitive sensitivity of such information. It would probably be unrealistic to expect companies to disclose, for example, emergent strategies, unintended consequences of actions, or their distinctive perspectives in perceiving events. However, since the relevance of these issues is well established in the literature, some caution is necessary when considering the ability of integrated reports to communicate the full range of factors affecting the creation of value over the short, medium, and long term.

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3

Value Creation: A Core Concept of Integrated Reporting

Axel Haller

Abstract The chapter analyzes the concept of value creation the International Integrated Reporting Council expresses in its Framework and its constructive components of stocks and flows of diverse capitals. The explanation and argumentation provided contribute to a deeper and clearer comprehension of the concept of Integrated Reporting (IR). Comparisons with value concepts, that have been developed in academic literature and by different institutions, such as Shareholder Value, Stakeholder Value, Shared Value and Public Value are made in order to show communalities and differences. Therefore, the chapter provides useful arguments and information to conceptually enhance the discussion about IR and its merits for society.

A. Haller (✉)

Chair of Financial Accounting and Auditing, University of Regensburg,
Regensburg, Germany

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Introduction

According to the International Integrated Reporting Council (IIRC) Framework, Integrated Reporting (IR) is defined as a “process founded on integrated thinking that results in a periodic integrated report by an organization about value creation over time and related communications regarding aspects of value creation” (IIRC 2013a, p. 33). Thus, the assessment, management and reporting of value created by an entity’s activities and its changes is key to the concept of IR (IIRC 2013a, p. 2). So, it focuses on the integral core of business models, the related objective of business activities and/or the motivation of people that are engaged in running a business, which has always been the creation of value. However, in its Framework, the IIRC does not refer to one of the value concepts that have been used in practice and academia over the last decades, nor did it provide a precise definition and/or formula by itself. It introduces a specific concept of value perception and assessment that leaves considerable room for interpretation. Against this background the objective of this chapter is to explain the IIRC’s value concept, put it in context to already existing value concepts and to propose an interpretation that triggers changes in business behavior in order to reach the final objective of IR, which is “financial stability and sustainability” (IIRC 2013a, p. 2).

Therefore the outline of the chapter is as follows. After a general analysis of the term “value” and its common interpretations in business, the IIRC’s value concept is described and interpreted. This is followed by a closer look at the major components of the value definition, the “capitals”. The chapter concludes with statements on how the IIRC’s value concept should be interpreted to reach the ultimate objective of IR, and how this is connected with the rationales governing the markets of financial capital.

The Concept of ‘Value’ in General

The notion “value” in general stands for the appreciation of the benefit(s) that a person (or a group of persons) perceives to gain from an issue or object. Value is therefore always bound to the perception of the person that does the assessment of the expected benefits, which can be tangible

or intangible (Fishburn 1964, p. 2). Thus, value assessment is absolutely subjective because it is the outcome of an individual perception of a particular person. It also depends on internal (personality, education etc.) and external (cultural, religious, regional etc.) factors related to the evaluating person, which can be quite stable over time or vary according to the particular situations the person is in (like stress, perceived particular scarcity etc.). This general fact is true for all different approaches and meanings of value that are used in society and that are shown in Fig. 3.1.

There is an economic value approach. This is characterized by assessing monetary measures to express the perceived benefit incorporated in the issue/object that is valued. Therefore in economic valuation only benefits that can be expressed in monetary terms are usually considered. This assessment through pricing is also restricted to perceived benefits that are identifiable and somehow exchangeable, because the monetary pricing takes usually place at markets where parties come together and bargain about the prices, which is nothing else than trying to converge their value assessments (Münstermann 1970, p. 11). These assessments take place for all tangible goods and services; thus most of the goods and services that are traded and exchanged on markets (machinery, property, financial instruments etc.). This also is true for intangibles that are identifiable and separable from a particular person and can therefore be traded (often called intellectual property, EU Commission 2014, p. 11; see also the definition of intangible assets of IAS 38).

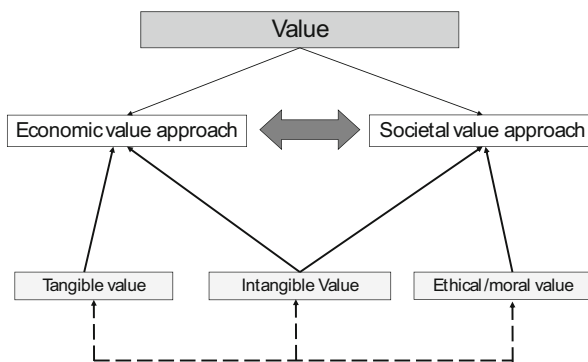


Fig. 3.1 Approaches and meanings of the notion “value”

However, there are also intangible values that are often related to knowledge, experience and know-how, of which the benefits are not identifiable, because they are non-detachably linked to particular people or brain pools, (IIRC 2013c, para. 19), for example the general level of education in a society or the organizational know how in a company. These are important benefits for the society and/or particular entities that can be appraised; however, in most cases they cannot be monetized. Nevertheless, there are attempts to create quantitative measures, like an average intelligence quotient or the quota of academics etc. These values form part of the societal value approach.

A third type of meaning of “value” is an ethical and moral one. This embraces beliefs or ideals that are fundamental for individuals and societies and help them interacting and functioning properly. They are very often related to religious or philosophical perceptions and principles, such as trust, love, confidence, respect etc. They are often expressed in codes of ethics or conducts or for a whole society in national constitutions. This type of value cannot be expressed in monetary or quantitative units; its assessment is just qualitative and highly judgmental. The assessment of this type of value is heavily culturally influenced and has a strong influence on the overall societal value perception.

Although these different kinds of values and value approaches can be analyzed separately, they are all linked together and interdependent (therefore the dotted lines in Fig. 3.1), and they all are related to the person that makes the evaluation (IIRC 2013c, para. 35).

The Concept of ‘Value’ Applied in Business

The interpretation and use of “value” in business has traditionally been reduced to the economic one, primarily because the measurability in monetary terms helps to aggregate, differentiate, and compare values in an effective and efficient way. Money was introduced to facilitate the value assessment in business life and to create comparability of values of different objects or issues that otherwise couldn’t be compared. It also has become a general perception in business that the concept of value and its assessment is dependent on the purpose of the assessment and the focus

on particular individuals, groups of people or the whole society (Sieben et al. 1974). While in national economics the value assessment embraces all people of a national economy by calculating measures, like the Gross Domestic Product for instance, the concept of 'value' in business primarily focuses on particular interest groups in micro economics, business sciences and practice.

This focus gets very obvious when it comes to the assessment of the value of a company that is often referred to as "business appraisal" or "business valuation". This type of value assessment is used in acquisitions of businesses and to determine the prices for equity shares on capital markets for example. Here, the appraisal is carried out from the standpoint of the (potential) owner of the business entity, usually referred to as "shareholder". This form of value assessment is captured by the concept and term of "Shareholder Value", which has been globally dominant over the last approximately 30 years. The concept, rooted in finance theory, was theoretically elaborated and propagated in the 1980s by Alfred Rappaport (1986) (also others like Copeland et al. 1990). It has a clear capital market focus and financial capital is the only resource that is considered. It is a monistic value concept, based on the estimated future cash flows and expected returns for equity and debt investments. It is characterized by a clear-cut monetary measurability and comparability, which facilitates its practical application and comprehension.

Despite the dominance of the Shareholder Value concept that focuses only on the value assessment of the equity holders there have always been academics and institutions around that have argued that the valuation of a business entity must have a broader scope, including the appraisals of all the groups of people that have stakes in the company, the so-called "stakeholders" (Freeman 1984; Donaldson and Preston 1995). Following this approach the value of a business entity consists of the sum of the appraisals carried out by the multiple stakeholders, meaning the people that are (in one form or another) impacted by the business activity of the entity. This appraisal is determined by the extent to which the entity has been able to meet the expectations of the particular interest groups. According to the type of relation these groups have with the entity, the so-called "Stakeholder Value" of an entity can be defined in a narrow or broad sense (Clarkson 1995). The narrow view embraces only the

impacts of people that have direct contact with the company (such as investors, creditors, suppliers, customers, and employees), whereas the broad view also includes the general public, non-governmental organizations (NGOs) and media etc. (Freeman et al. 2007, p. 7). The major challenge of this concept is that the different stakeholders often have divergent or conflicting value appraisals, that may not be measurable in monetary terms and that are not necessarily addable and comparable. Thus the Stakeholder Value is a multiple-component value concept that consists of several individually assessed measures that have to be evaluated against each other to come to a combined value judgment (Harrison et al. 2010). Hence, this value concept is multi-dimensional, not (only) monetary, and has a lack of generally agreed on standards to evaluate the multiple value factors. This fact makes it complex and negatively impacts its application in practice.

As the Stakeholder Value concept primarily focuses on groups of people with particular functions, relationships and/or interests connected to a business entity it does not explicitly include the natural environment, even though it is impacted by the activity of a business entity. Therefore most of the different Stakeholder Value approaches that have been proposed in literature do not include the ecological effects of business.

A concept that goes even further than the Stakeholder Value concept is the so called “Public Value” concept that was developed by Mark Moore (1995) for public entities to improve and target their strategies. Public Value embraces all the contributions of an entity to society and its functioning that are perceived by the members of society, meaning all impacts of an entity’s actions on the people and their environment (including ecological). It is created when a firm’s action (e.g., via its products or services) leads to a positive evaluation of needs fulfillment (Moore and Khargram 2004). As with the Stakeholder Value, the Public Value is neither a monetary nor a monistic value concept. As it is based on perceptions, it is highly judgmental, but it is very comprehensive (Alford and O’Flynn 2009, p. 175). The concept points out (related to the subjectivity of valuation mentioned in Chap. 2) that no value can simply be “created,” it always needs an audience to appreciate it (Meynhardt et al. 2014, p. 5). Therefore, in order to “create” value entities need an elaborated sense of society’s expectations and of their needs to better legitimize their actions

(Moore and Khargram 2004). Public Value may be interpreted more as a social value concept than an economic one. It is still theoretical, however there are attempts to apply it in practice (for instance researchers from the University of St. Gallen, Switzerland, have developed a strategic management tool, called Public Value Scorecard, Meynhardt et al. 2014, p. 5).

These three concepts of value are the major conceptual angles of how to appraise the value that a business entity has or represents. They all have in common that they are related to the appraisals made by people. These appraisals depend all to a large extent on the expectations the particular persons have pertaining the entity.

The Concept of Value in the IIRC's Framework

Against this conceptual background the IIRC had to define its perception of value and value creation. Looking at the published documents over the period of the Framework's development it is traceable that the IIRC's wording concerning value creation has changed over time; the original sustainability focus—in a sense of a “triple bottom line” (with the three dimensions of economy, ecology and social, Elkington 1997)—has evaporated in text and the financial capital providers became the targeted users of the Integrated Report (Haller and Zellner 2014, p. 254). This obvious fact has been criticized in literature (for instance, Flower 2015). However, reading the Framework carefully and taking into account the background papers (IIRC 2013b, c) raises considerable doubts whether this criticism is justified with regard to the overall conceptual reasoning of the IIRC. Hence, the changes in wording might have had political reasons (power games that were going on within the constituting groups of the IIRC), but the statements in the Framework still allow a very Stakeholder or even Public Value oriented interpretation of the IIRC's concept of value creation.

Because of the statements like: “The primary purpose of an integrated report is to explain to providers of financial capital how an organization creates value over time” (IIRC 2013a, para. 1.7; see also 2013a, pp. 2, 4) or that IR should enable financial capital providers to “a more efficient and productive allocation of capital” (IIRC 2013a, p. 2), the interpretation that the IIRC follows a value concept that is embossed by the Shareholder

Value seems to be self-evident. However, despite this explicit targeting toward the investors, the IIRC did find a diplomatic and practical solution to bridge the conceptual gap between a financial capital provider's focused value concept and a sustainability and stakeholder oriented one. It introduced a value concept that has two aspects, which are stated to be strongly interrelated (IIRC 2013a, para. 2.6; 2013c, para. 9 et sequ.) The first aspect is very much linked to the explicit capital provider focus of IR and is referred to as the "value created for the organization". It is defined as the value, "which enables financial returns to the providers of financial capital" (IIRC 2013a, para. 2.4). Although the term is highly debatable (because the organization consists not only of the financial capital providers) it expresses the fact that in legal terms the organization belongs to and is primarily governed by the financial capital providers. This approach of the "value for the organization" resembles the "entity approach" to calculate Shareholder Value (Haller and Zellern 2014, p. 254). It represents the market value of the whole business, which is equity and debt capital. Despite this clear link to the Shareholder Value concept, the IIRC does not mention this concept at all in its Framework, rather it states clearly in its background paper "financial value is relevant, but not sufficient, for assessing value creation" (IIRC 2013a, para. 14).

In order to express this notion in the Framework the IIRC introduced a second aspect of value, which is the "value created for others". This value is based on the perception that the "ability of an organization to create value for itself is linked to the value it creates for others" (IIRC 2013a, para. 2.6). This value aspect is less precisely explained than the "value for the organization", however some characteristics of it can be extracted from the Framework:

- The expression "others" embraces the "stakeholders and the society as a whole" (IIRC 2013a, para 2.4).
- The value includes all externalities ("costs or other effects on capitals that are not owned by the organization", IIRC 2013a, para. 2.7) caused by an entity's activities, relationships and interactions (IIRC 2013a, para. 2.6).
- It is evaluated through the impacts of an entity on other types of capitals than financial capital (IIRC 2013a, para. 2.7).

Although, this value aspect resembles the stakeholder or public value, it has a major qualification according to the wording of the Framework. It covers only impacts for stakeholders and the public, if these are linked to the ability of the organization to create value for itself (IIRC 2013a, para. 2.5 and 2.7). Therefore the IIRC mentions examples like customer satisfaction, suppliers' willingness to trade with the organization, the organization's reputation, conditions imposed on the organization's social license to operate, and the imposition of supply chain conditions or legal requirements (IIRC 2013a, para. 2.6). This qualification relates the value concept of the IIRC to the Shared Value concept that has been developed and popularized by academics from the Harvard Business School around Michael Porter several years ago (see Porter and Kramer 2011; Porter et al. 2013). This concept, developed for profitable business strategies (for a deep analysis of the concept see Crane et al. 2014), may be described by a Shareholder Value concept that includes societal impacts as major drivers of the value parameters (cash flows, risks and discount rate). Its protagonists explicitly distinguish the Shared Value concept from the Stakeholder Value one, and express that Shared Value should not be confined with a philanthropic approach (Porter and Kramer 2011, p. 77; Porter et al. 2013, p. 10 sequ.). The core of the concept is the "business case of sustainability" (Porter et al. 2013, p. 4; critical Crane et al. 2014, p. 134), which notes that including environmental, social and corporate governance (ESG) aspects in the strategies and decisions of corporate management often leads to higher shareholder returns, and is therefore rational and profitable from a shareholder perspective (Porter and Kramer 2011, pp. 64 et sequ.). Hence, the motivation for including sustainability concerns in business strategy is a clear shareholder-focused economic and not a societal one (Crane et al. 2014, p. 142). Although the concept of Shared Value has been propagated already for several years, has gained a substantial and positive audience in practice and academia (Crane et al. 2014, pp. 132–133), and has triggered a whole global initiative (Shared Value Initiative 2015) as well as a consulting business (see Foundation Strategy Group 2015), it is not yet clearly explained how the impacts can quantitatively be included in the Shareholder Value formula (although there are some case studies provided, for instance in Porter et al. 2013). This view of a business case for sustainability is also incurred by many

research studies that investigate whether the incorporation of ESG factors in business practice have a positive influence on the major determinants of the Shareholder Value of an entity, which are cost of capital, operational performance, and stock price performance (for an overview of such studies see for instance Orlitzky et al. 2003; Clark et al. 2014).

Deviating from this “business case of sustainability”—angle the IIRC notes in the Framework that there might also be financial capital providers that do not only have interest in the “value for the others” when it affects the “ability of the organization to create value for itself”, but also when it “relates to a stated objective of the organization (e.g., an explicit social purpose) that affects their assessment” (IIRC 2013a, para. 2.5). This situation happens either when the entity is a non-profit and/or public organization (entity forms that are also included in the scope of the Framework; see IIRC 2013a, para. 1.4) or when the investors do not just follow an economic but a societal rational. This statement is very important for the interpretation of the IIRC’s value concept, because it points out that the more the two value aspects (“value for the entity” and “value for the others”) overlap (converge) the more investors include social, environmental and public aspects in their value assessments (IIRC 2013c, para. 26 and 43; 2015; this will be further discussed in the last chapter).

The Capitals: Major Value Components

Based on the two value aspects that can clearly be related to the “economic value” and “social value” concepts that were explained in Chap. 2 the Framework states that “value created by an organization over time manifests itself in increases, decreases or transformations of the capitals caused by the organization’s business activities and outputs” (IIRC 2013a, para. 2.4 and p. 33). This definition clearly stresses the above mentioned argument that the IIRC’s value concept is ultimately not focused on the value that is assessed according to the financial capital but by including all different sorts of capital (IIRC 2013b, para. 3.1 et sequ.; 2013c, para. 32). This perception is affirmed by the clear statement that it is unlikely that value creation on a long term can happen “through the maximization of one capital, while disregarding the others” (IIRC 2013a, para. 2.9).

The capitals are referred to as being “stocks of value that are increased, decreased or transformed through the activities and outputs of the organization” (IIRC 2013a, para. 2.11). They encompass resources and relationships the entity is dependent on and which it uses and affects (IIRC 2013a, para. 2.3). The value determining effects on the capitals are called “inputs”, “outputs” and “outcome” (IIRC 2013a, para. 2.23; 2013b; SAICA 2015, p. 12). In an entity the “overall stock of capitals is not fixed over time. There is a constant flow between and within the capitals as they are increased, decreased or transformed” (IIRC, para. 2.12). The IIRC is not silent about the fact that the measurement and evaluation of changes in capitals is often complex (IIRC 2013a, para. 2.14; 2013c, para. 54), and that in particular circumstances value creation may also include situations where the stock of a particular capital rests unchanged or even is decreased, e.g. when the diminishing of natural capital has been reduced (IIRC 2013a, para. 2.14), and that the effects can even be conflicting (IIRC 2013a, para. 2.9).

The IIRC defines six capitals that represent all different types of resources an entity uses or impacts; these are not directly associated with particular stakeholder groups (Bartolini et al. 2013, p. 130). Although the IIRC states clearly that “organizations preparing an integrated report are not required to adopt this categorization” (IIRC 2013a, para. 2.10, 2.17; for other alternatives see IIRC 2013b, para. 4.5 et sequ.), it is very likely that this categorization will become the standard for IR, because it is very inclusive and clear-cut.

The six capitals with their definitions provided by the IIRC are (IIRC 2013a, para. 2.15; 2013b, para. 4.5 et sequ.):

- Financial capital: Pool of funds that is used in an entity’s business model and is obtained “through financing, such as debt, equity or grants, or generated through operations or investments”;
- Manufactured capital: manufactured physical objects (other than natural ones) “that are available to an entity for use in the production of goods or the provision of services” (such as buildings, equipment etc.) including the infrastructure outside the entity (for instance roads, bridges, ports or water treatment plants);

- Intellectual capital: “organizational, knowledge based intangibles”, such as intellectual property (patents, copyrights, software, licenses, etc.) and “organizational capital” (tacit knowledge, systems, procedures and protocols, etc.);
- Human capital: “people’s competencies, capabilities, and experience, and their motivations to innovate” (for instance ethical values, alignment with an organization’s governance framework, ability to develop and implement an entity’s strategy, or to lead and manage etc.);
- Social and relationship capital: “the institutions and the relationships within and between communities, groups of stakeholders and other networks, and the ability to share information to enhance individual and collective well-being. It includes shared norms, common values and behavior, key stakeholder relationships, intangibles related to the brand and reputation of the organization, and “an organization’s social license to operate”;
- Natural capital: “all renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current or future prosperity of an organization”, including land, minerals, forests, water, air, biodiversity and eco-system health.

The capitals serve as a part of the theoretical underpinning of the whole value concept and as a guideline for companies to have a more comprehensive view of their value creation (IIRC 2013a, para. 2.17; 2013b, para. 4.1) that should safeguard that an entity considers all important resources, which it uses or affects (IIRC 2013a, para. 2.19). Although the capitals are key to IIRC’s value concept, the IIRC does not specify how the capitals and changes in capital can or should be measured (IIRC 2013a, para. 1.10; 2013b, para. 3.5). The Framework doesn’t even refer to specific approaches that have already been developed to measure particular capitals individually or in bundles together. Many institutions and initiatives have been worked or still work at these measures, such as for instance the Working Group “Accounting and Reporting of Intangibles” of the Schmalenbach Association for Business Administration 2005 (Intellectual Capital Statement), the Natural Capital Coalition 2015 (Natural Capital Protocol), the Carbon Disclosure Project 2015 (Carbon Disclosure Project), KPMG 2014 (True Value),

New Economics Foundation 2015 (Social Return on Investment), World Business Council of Sustainable Development 2015 (Redefining Value), EFFAS/DVFA 2010 (ESG KPIs); Global Reporting Initiative 2013 (G4 Guidelines). Because the choice of evaluation methods determines the value assessment of the capitals, the Framework requires to state the approaches, methods, and definitions used to quantify or evaluate material components of the value creation assessment and/or refer to those statements provided in other of the entity's reports and communications (IIRC 2013a, para. 4.47). If value measures of particular capitals (like financial capital) are used in other reports (such as financial statements) the measures that are part of the overall value assessment should be identical or easily reconcilable with these measures (IIRC 2013a, para. 4.48).

Key Performance Indicators (KPIs) do have an important function in a lot of value or capital assessment approaches (IIRC 2013b, para. 3.5; IIRC). With them, on a certain level of objectivity, non-monetary data can be quantitatively assessed and changes in stocks of capital can be expressed and compared over time and between entities (Bartolini et al. 2013, pp. 132–135). Thus, they are “value indicators”. However, they can't be used for all capital aspects and—in order to be useful—they need to fulfill certain qualitative characteristics (IIRC 2013a, para. 1.11, 3.8, 4.53; Bartolini et al. 2013, pp. 134–135).

Along with the materiality principle, which is key for IR (IIRC 2013d), the assessment of the value creation should focus on the capitals that are material for either the entity or its environment (IIRC 2013a, para. 2.7; 2013c, para. 48 et sequ.). Thus, not every entity has to consider all the six capitals in its value appraisal (IIRC 2013a, para. 2.16), and particular capitals may be more or less relevant for particular entities or industries for the overall value assessment, which can vary over time (SAICA 2015, p. 10).

Hence, a closer look at the Framework reveals that the IIRC ultimately does not follow a value concept of one monistic value, which would even be impossible with regard to all the different capitals. The concept of looking at the capitals differently implies a multi-dimensional value concept like the Stakeholder and Public Value concept (IIRC 2013c, para. 15, 29, 40, 44; SAICA is more explicit about its stakeholder orientation in IR; SAICA 2015, p. 9). Measuring the integrated performance (= value creation) of a business just by one measure seems not to be realistic (Bartolini

et al. 2013, p. 136). Especially because of the subjective character of evaluations (see Chap. 2), single data (KPIs etc.) representing increases or decreases of each particular capital should be provided for evaluations inside and outside the entity. On the base of this multi-dimensional portfolio of partial values (for an example see Bartolini et al. 2013, pp. 136–142) each individual need to make his assessment of the “overall stock of capitals” which is core to IR (IIRC 2013a, para. 2.14). This evaluation most likely depends on the stakeholder group, individual situation and satisfaction of the evaluator (Bartolini et al. 2013, p. 134).

The IIRC’s Value Concept: A Move to Change Business Behavior

As mentioned above, the idea of the IIRC to introduce a value concept with “two interrelated aspects” (IIRC 2013a, para. 2.4) that are specifically addressed and provided with labels that have not been used before in practice or academia and that can therefore not directly be related to existing ones, was a great diplomatic move by the IIRC. On the one hand the explanations in the Framework give guidance and on the other they leave enough room for interpretation and further development. The major characteristics of the IIRC’s concept are the following; they are core to IR:

1. The value concept is not a monistic one. Two interconnected value aspects have to be considered.
2. The components of value are stocks of various types of capital.
3. Value creation is changes (increases, decreases, transformations) in those stocks.
4. If feasible, the evaluation of those changes should be monetary or quantitative, if not, it should be qualitative (a lack of monetary measurement does not exclude a value factor from the assessment).
5. It is up to the management of the entity to define its own way of how to assess the value. However, the evaluation is only as good as it considers the expectations and value perceptions of the relevant stakeholders.

With these characteristics the IIRC's value concept builds a bridge between the traditional value assessment in business (Shareholder Value) and the modern, prospective one that needs to be considered in the future, due to the increasing societal, ecological and existential pressures and needs (IIRC 2013c, para. 11). It also clearly connects—as already mentioned above—the economic and the societal meaning of value. It stresses the fact, that the monetary value appraisal of financial capital is only one aspect (however nevertheless an important one) of the multi-dimensional value perception that includes other resources that are positively and negatively impacted by the business (IIRC 2013c, para. 15, 29; 2014). With the capitals as major value components the concept is more concrete as for instance the Public Value concept. In addition, with its proximity to the concept of Shared Value and thus its focus on financial capital providers it is not in conflict with the main stream thinking and approaches in business but enriches them; notably, with the perception that an entity's value for investors is directly influenced by other stakeholders' value appreciations with regard to different types of resources the entity is using or affecting (IIRC 2013a, para. 40 and 44). Although not explicitly stated in the Framework, the following concluding sentence in one of its background papers shows clearly that the IIRC has a value concept in mind that is very different from a Shareholder or even Shared Value concept (for the societal weaknesses of this concept see Crane et al. 2014, pp. 134 et sequ.): “Ultimately value is to be interpreted by reference to thresholds and parameters established through stakeholder engagement and evidence about the carrying capacity and limits of resources on which stakeholders and companies rely for well-being and profit, as well as evidence about societal expectations” (IIRC 2013c, para. 58).

The superficial investor focus expressed in the Framework is a clever and sensible political step to increase the acceptance of IR in the business community and it is also related to the fact that in reality—undoubtedly—primarily investors decide on an entity's business model, strategies and decisions taken etc. because they appoint and dismiss the board of directors and decide on the provision of cash, which is the “fuel” that is needed to keep the entity running. Therefore, through this decisive power position investors have a key role for the value concept applied in

the top management's strategies and decisions, whether it includes just one sort of capital or whether it is more comprehensive.

This is the reason why integrated thinking (IIRC 2013a, pp. 2 and 33 and para. 3.13; SAICA 2015) in corporate decision making (in a way of equally incorporating different interests and value impacts as well as considering their connectivity) will only happen in corporate practice, when the providers of financial capital appoint managers that are willing and able to apply this management concept. Most likely this is only the case when the capital providers apply this thinking themselves in their capital allocation decisions; meaning that they need to adopt a value concept that assesses financial capital return only as one factor besides several others that appraise the societal, ecological and moral aspects of "value" (IIRC 2013c, para. 35). Hence, the "rules of the game", which determine decision making on the financial capital market(s) need to be changed in order to change corporate behavior (IIRC 2015). Thus, integrated thinking in companies depends on integrated thinking on stock exchanges, in investment institutions, banks and other capital providers (so called "investment value chain", Gore and Blood 2011; Aviva 2014). Here, first steps have already been made in particular through the Principles of Responsible Investment (PRI) initiative (PRI 2015), the Sustainable Stock Exchanges Initiative (SSE 2015), the International Corporate Governance Network Principles (ICGN 2014, for instance principle 10.4c), the general approach of a long-term investment focus (KPMG 2014, p. 95; ACCA 2013, p. 20; Barton and Wiseman 2014; Focusing Capital on the Long Term 2015) and the increasing implementation of ESG factors in investors' decision making (PWC 2012; EY 2014). However, the idea of integrated thinking has by far not become mainstream on capital markets, neither on a national nor on a global level.

This change in appreciation of multiple value attributes may happen, if the investors perceive themselves as an important part of society with major responsibility for its current and future evolution (which for sure is a pure value judgment), and exercise an "active ownership" role (Clark et al. 2014, p. 42). This change in mind-set by more and more investors will increasingly lead to a convergence of the Shareholder Value and the Public Value, and therefore to a positive future prospect of society. This type of thinking may be stimulated by the consideration of the fact that

the people acting on the capital markets are not only restricted to this particular function in society, but are also citizens and human beings that absolutely depend on the wellbeing of society and the ecological environment; therefore shareholders just have to consider that they are (also) stakeholders (Clark et al. 2014, p. 44).

If this perceptual and rational change takes place in daily business (practice and academia) then the IIRC's value concept becomes reality, because the "value created for the organization" really is inseparably intertwined with the "value for others" through the application of "integrated thinking". However, the concept of IR alone will not be able to reach this decisive change in thinking and acting on capital markets, however it has the potential to be an important piece of the whole puzzle that is needed to be laid out. In this respect, the IIRC is right in expressing its expectation that "the cycle of integrated thinking and reporting, resulting in efficient and productive capital allocation, will act as a force for financial stability and sustainability" (IIRC 2013a, p. 2).

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4

Empirical Evidence on Current Integrated Reporting Practices

Carlo Marcon and Moreno Mancin

Abstract Due to the emerging nature of Integrated Reporting, little is known about how companies are preparing their reports. In order to reduce this gap of knowledge, the chapter aims at analyzing the content and quality of the 2013 and 2009 integrated annual reports of the companies engaging in the Pilot Program Business Network of the International Integrated Reporting Council (IIRC) in order to assess the degree of compliance with the IIRC Framework in 2013 and the evolution of IR disclosure quality from 2009 to 2013. The research findings highlight a certain resistance from the companies to adhere to the spirit of IR, although the judgment of overall compliance should be considered positive both in absolute terms, as well as compared to the 2009 results.

C. Marcon (✉) • M. Mancin
Department of Management, Ca' Foscari University of Venice, Venice, Italy

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Critical Issues and Theoretical Background

This chapter aims to assess whether the disclosure of financial and non-financial information within annual reports has improved over time with the adoption of integrated reporting (IR).

IR emerged in order to overcome the critical issues of traditional corporate reporting. These limitations may be grouped into three categories: complexity, lack of connectivity, and lack of forward-looking information.

In the last few decades, traditional annual reports have become steadily more complex and longer, due to the growing complexity of the business world, which has led to new and extensive reporting requirements (Daub 2007). The resulting information overload makes it increasingly difficult for users to extract the relevant information they need (Plumee 2003; Miller 2010). According to the International Integrated Reporting Council (IIRC), IR is the appropriate way to face this issue because it should lead to one concise primary report containing only material information.

The second critical issue is related to the fact that there is not enough non-financial information in traditional annual reports, or, if it does have a sufficient presence, it is not adequately linked with the financial information. Many studies have demonstrated that non-financial information allows users to better understand the overall performance and the intangible value of a company (see, among others, Amir and Lev 1996; Fifka and Drabble 2012). Although information on environmental, social and governance issues has increased over time, the level of integration with financial disclosure is low (Lozano and Huisingh 2011). Financial statements, management commentary, the corporate governance report and the sustainability report currently form isolated parts within the annual report, or are even published separately from it. Contrary to this, IR has the potential to incorporate sustainability reporting into financial reporting in order to present a more holistic picture of the business, emphasizing the connectivity of all factors that affect the organization's ability to create value over time.

Finally, traditional corporate reporting lacks forward-looking information and provides limited usefulness in predicting the long-term performance of a company. IR should go beyond past-oriented financial

information, clearly disclosing the strategic objectives for the future and strategies for achieving them, the future outlook of performance, and the relationship between past and future performance.

In order to overcome the above-mentioned critical issues, some pioneering companies began drawing up the first integrated reports in the early 2000s.¹ Since that moment, a small but increasing number of companies have adopted IR. Based on Global Reporting Initiative (GRI) data, only 1.3 % of the world's 46,000 listed companies were self-declared integrated reporters in 2012, but that number grew from 287 in 2010 to 596 in 2012. However, up until 2013 no clear and common guidance existed with the consequence of generating heterogeneous practices. In December 2013, IIRC issued the International Integrated Reporting Framework, which gives us the opportunity to assess the degree of IR disclosure in terms of compliance with its requirements.

Due to the emerging nature of this kind of reporting, most contributions are theoretical, while little is known about how companies are preparing their integrated reports.

Some theoretical studies have reported on the status and evolution of IR (Eccles et al. 2015a), whereas others have underlined the benefits and challenges to be faced (Roth 2014; Adams 2015). Moreover, some have identified a range of future research opportunities and possible improvements to the IR Framework (Cheng et al. 2014). Finally, there are also those who have expressed very critical views on the IIRC, even judging this initiative as a failure, compared to its original aims (Flower 2015).

As regards the empirical studies, they may be divided by methodology, into three main groups.

The first group consists of contributions based on the case-study approach, encompassing document analysis and in-depth interviews. They intend to shed light on the way in which IR is currently being adopted by exploring some leading examples of IR practice (e.g. Eni, Eskom, Sap, Takeda), in order to assess the assimilation of IR principles (Busco et al. 2013; Dumitru and Jinga 2015; Lodhia 2015). Notably, Eccles et al. (2015b) reviewed the randomly selected integrated reports of 25 multinational companies that

¹ The earliest integrated reporters were two Danish companies (Novozymes and Novo Nordisk) and a Brazilian company (Natura).

participated in the IIRC's Pilot Program Business Network. Rather than attempting to assess the quality of entire integrated reports, they looked for examples of best practices by focusing on three related elements: strategic focus, connectivity of information, and materiality.

The second group is composed of surveys aimed at understanding the impact of IR from both the user and the preparer perspective. Through an online survey, Rensburg and Botha (2014) found that very few investors use IRs as their main source of information and that these reports are seen as additional information. Ballou et al. (2012) reported the results of a survey of 178 corporate responsibility officers, designed to explore how accountants can add value to the integration of sustainability initiatives into financial reporting.

The third field of empirical study assesses the degree of IR adoption and its determinants by using content analysis and a quantitative approach. Some of these studies investigate why companies are producing IRs by analyzing the firm-specific variables or country-level determinants, which could be associated with the decision to disclose an integrated report. Frias-Aceituno et al. (2013a) examine 568 non-financial companies from 15 countries and conclude that the size of a company, its management bodies, and its gender diversity are the main factors in the decision to disclose IR. Based on 7,144 worldwide observations, Sierra-Garcia et al. (2013) point out that the likelihood of preparing an integrated report is positively associated with having an assured corporate social responsibility report. Based on institutional theory, Jensen and Berg (2012) show, in a sample of 309 firms, that IR companies are different from traditional sustainability reporting companies with regard to several institutional factors. Finally, Frias-Aceituno et al. (2013b) find, in a sample of 750 international companies, that those located in civil law countries and where indices of law and order are high are more likely to publish an IR.

Differently from the studies cited above, Churet and Eccles (2014) and Berndt et al. (2014) try to evaluate the content of IR rather than simply its adoption. Churet and Eccles (2014) conducted a search for a number of specific indicators of IR in the 2011 and 2012 annual reports of 2000 companies. They pointed out that the percentage of companies practicing IR grew 50 % from 2011 to 2012 and they also found a statistically significant relationship between the practice of IR and quality on environmental, social and governance management, while no statistically

significant correlation between IR and financial performance was found. Berndt et al. (2014) developed a set of criteria based on the requirements of the IR Framework in order to assess the extent to which the 20 largest companies that constitute the Swiss Market Index have adopted the principles of IR. They showed that companies officially publishing IR got a significantly higher score than the rest of the sample.

Our study belongs to this last strand of research and is closely related to Berndt et al. (2014) and Churet and Eccles (2014). However, our contribution is different from the former because of our sample, which is larger, with firms from all parts of the world, and from the latter because of our kind of analysis, as we assessed the entire integrated annual reports and not only proxies for IR.²

Notably, we analyzed the content and quality of the 2013 and 2009 integrated annual reports of the companies engaging in the IIRC's Pilot Program Business Network in order to assess: (1) the degree of compliance with the IR Framework in 2013 and (2) the evolution of IR disclosure quality from 2009 to 2013.

The remainder of the chapter is organized as follows: the second section describes our sample and methodology, while the third presents our overall findings. In section “[Content Elements and Capitals: Analysis of Empirical Results](#)”, we analyze the results divided by capitals and content elements and, in section “[Compliance Score and Conciseness Index per Region](#)”, we discuss the same results by region.

Finally, the last section provides some concluding remarks on the process of adjustment from traditional reporting to IR based on the results of our empirical analysis.

Sample and Methodology

As mentioned above, our sample is composed by companies that participated in the IIRC's Pilot Program Business Network, which came to an end in September 2014 after 3 years of testing the principles

² Churet and Eccles (2014) looked for examples of environmental or social initiatives that led to either cost savings or new revenue streams.

behind IR. These organizations, being committed to the adoption of IR, should represent excellence in IR practices. In September 2014, the number of Pilot Program organizations was 104. We decided not to include non-profit organizations (eight) in order to increase the comparability among entities. Moreover, 20 other firms were excluded because their integrated reports or annual reports were not available for both 2009 (the year before the foundation of IIRC) and 2013. Following this selection process, our sample consists of 76 companies, for a total of 152 reports analyzed.³

Although some companies publish stand-alone sustainability reports, our analysis is focused only on the information available within one report (the integrated report or, in its absence, the annual report). Each report was evaluated by a predefined set of criteria based on the requirements of the IR Framework. In order to provide some objective basis for our assessment, the set of criteria consists of some binary format questions, where the answer “yes” receives 1 point and the answer “no” gets a score of 0. In identifying the questions, we considered that they were compliant with the IR Framework as much as possible, verifiable by an external user, relevant in capturing the value creation process, and in the “spirit” of IR.

A total of 72 questions were included in the overall evaluation for analysis purposes: 37 questions related to the six capitals (financial, manufactured, intellectual, human, social and relationship, natural) and 35 questions related to the content elements. Even though we did not identify specific questions related to the guiding principles, some of them may be evaluated indirectly through the analysis of capitals and content elements.

Since one characteristic of IR is conciseness, it is useful to consider, in addition to the integrated reporting score, the density of information as well, which expresses the contained information in relation to the report’s length and can be measured with a points-per-page indicator.

³Analyzing the reports took approximately 600 man hours.

Overall Findings

Before disclosing the assessment of content results, we will show some information related to the format used for the presentation of the integrated reports in 2013.

As can be seen in Table 4.1, most companies in our sample (45 %) presented an annual integrated report combining financial statements and sustainability reports in one single document, while only 21 % of companies published a stand-alone integrated report separate from the annual report and 3 % of firms dedicated a specific section within the annual report to IR. Surprisingly, 32 % of organizations in our sample, though participating in the Pilot Program, did not explicitly state that they had issued an integrated report.

Moreover, we collected some preliminary information about the use of technology-based documents. While all firms provided their reports online in the form of a printable document, more than half of them (53 %) also used a technology-based format with linked web-pages in order to provide users with additional information on demand and foster the connectivity of information.

As regards the analysis of the content, the average compliance score grew from 49 % (35.3 out of 72 total points) in 2009 to 62 % (44.9 out of 72 total points) in 2013. Moreover, less than half of the companies in our sample had a compliance score over 50 % in 2009, while 86 % of sampled firms got a score over 50 % in 2013. These data demonstrate a clear improvement in the degree of IR disclosure, even though the score of 62 % reached in 2013 does not seem very high, considering that companies in our sample should represent the best practice in IR. However, it is important to remember that the IR Framework was

Table 4.1 Typology of document

	Stand-alone integrated report	Section dedicated to IR	Annual integrated report	Non self-declared IR
2013				
Number	16	2	34	24
Percentage	21	3	45	32

Source: our database from a sample of IIRC' Pilot Program companies

issued in December 2013 and many companies are only at the beginning of their journey toward IR. Furthermore, the compliance score would be likely higher if the requirements of the Framework were more detailed.

For stakeholders, it is not only important that all relevant information is included in the report, but also that it is easy to find. Therefore, we tried to measure the IR guiding principle of “conciseness” with a points-per-page indicator. This information density score grew from 0.27 points-per-page in 2009 to 0.35 in 2013, representing a 30 % increase. However, this improvement is mostly due to content rather than to the length of the reports, which has decreased only by four pages (from an average number of pages of 191 in 2009 to 187 in 2013).

In addition, the correlation between the number of pages and the compliance score is slightly positive (0.06 in 2013 and 0.15 in 2009), while the correlation between length and the information density score is negative (-0.75 in 2013 and -0.71 in 2009). Hence, the information does not increase at the same rate as the length of the reports. Accordingly, although longer reports tend to have a higher compliance score, shorter reports have a higher density of information.

Remembering that some sampled companies do not explicitly claim to have issued an integrated report, we compare the 52 IRs (comprising stand-alone integrated reports, annual integrated reports and annual reports with a section dedicated to IR) to the 24 non self-declared IRs for the year 2013. The first category results in an average compliance score of 66 %, while the second a score of 55 %. Moreover, the average number of pages for IRs is 161, which is 82 pages shorter than the average length of 243 pages in the other category. As a consequence, the information density ratio for companies that officially publish IRs is double that of the rest, namely 0.41 compared to 0.21. These results could suggest that some companies participated in the Pilot Program simply for a matter of visibility, without real commitment.

Finally, by comparing the 16 stand-alone integrated reports to the 34 annual integrated reports, we find no significant difference between the average compliance scores (65.9 % vs. 65.6 %). However, stand-alone IRs have a higher information density score than annual integrated reports (0.56 vs. 0.36) due to their shorter lengths (105 pages compared to 175). This evidence may hint at the existence of a conflicting trade-off

between conciseness and the idea of one single report. In other words, when companies prepare a concise IR, it represents an additional report alongside conventional financial statements and even sustainability reports; otherwise, when companies draw up an annual integrated report, it is often one single report, but is unavoidably longer.

Content Elements and Capitals: Analysis of Empirical Results

In this section we will provide some detailed analysis of the key results shown in the previous section, with the goal of reaching a deeper understanding of the informational content that recorded the most significant compliance rates, and of the results that were less coherent with the provisions of the Framework. We will proceed by keeping the scores obtained in the disclosure of single capitals distinct from those observed for content elements.

The results of the analysis of capitals are reported in the following Table 4.2, which illustrates the average score obtained for each item of the survey performed in the 2 years under investigation.

We decided to set up a cross-question aimed at verifying if IR provided a categorization of capitals used by the firm and if those capitals were presented in a structured way, explaining the interrelationships existing between them. The importance of the presentation of capitals used and

Table 4.2 Average compliance score in capitals' disclosure

	n. item	2013		2009		Variation	
		Score	%	Score	%	Abs.	%
Categorization	1	0.2	24	0.01	1	0.23	23
Financial	6	5.0	83	4.6	76	0.4	7
Manufactured	6	3.66	61	3.2	54	0.46	7
Intellectual	6	3.72	62	2.7	45	1.02	17
Human	6	4.4	73	3.5	59	0.9	14
Social and relationship	6	4.8	79	4.0	67	0,8	12
Natural	6	3.9	65	3.3	54	0.6	11
Total	37	25.6	69	21.3	58	4.3	11

Source: our database from a sample of IIRC' Pilot Program companies

of the relationships between them is also illustrated in the Framework, which points out that the firm does not necessarily have to refer to the six types of capital listed in this document, but may use different categories based on the activities performed and the business model adopted. The same Framework provides for their identification both as part of a theoretical underpinning for the concept of value creation either as a guideline for ensuring that organizations consider all the forms of capital they use or affect. However, despite the relevance the Framework attributes to the identification of capitals used by the firm, the reports show a lack of attention to this information, reaching an average score of 0.2, or 24 %, compliance in our 2013 sample. It is also true that the disclosure on the categorization of capitals registers the most significant growth rate, with a variation of 23 % compared to the corresponding result in 2009, when only one firm, on a completely voluntary basis, reported a classification of capitals compliant with the Framework.

Concerning the individual categories of capitals, it is important to note that no IR in the sample, essentially, strayed from the classification of capitals adopted by the IIRC. The results confirm a strong compliance in the reports, compared to what was expected from the Framework. The average recorded data on the individual capitals fluctuate within a range from a minimum score of 61 %, recorded for the Manufactured capital, to a maximum score of 83 %, recorded for Financial capital. In interpreting the results of Table 4.2, we must also consider that not all capitals carry the same importance in the different companies. While most organizations interact with all capitals to some extent, these interactions might be relatively minor or indirect: very probably, some firms decided not to record some capitals or to dedicate less attention to them in the corresponding reports. For example, Manufactured capital—which presents the lowest average score among the capitals—delivered very high results (above 4.5 out of 6) for organizations in which that capital plays a fundamental strategic role in the business model, as observed for the companies operating in the Oil & Gas sector, companies concerned with the working of raw materials and natural resources, in the pharmaceutical industry, and in the telecommunications sector. On the contrary, the same capital registered rather low scores in the sectors where it does not, generally, have a determining role, for example, for the firms that

offer professional and financial services, with average scores lower than 2 points out of 6 (33 %).

This interpretation seems to be confirmed by the analysis of the Social & Relationship Capital, which represents the second capital in average compliance score observed in both years (79 % in 2013 and 67 % in 2012). According to the Framework, social and relationship capital includes shared norms, common values and behaviors, key stakeholder relationships, the trust and willingness to engage that an organization has developed and strives to build and protect with external stakeholders, intangibles associated with the brand, and the reputation that an organization has developed. This is, evidently, a form of capital relevant for every type of firm, regardless of the activities performed, the business model adopted, or the main sector in which it operates.

Shifting our attention to the analysis of the 2009 data, the average compliance score is equal to 58 %, with a particularly low quality of information: 4 out of 6 capitals do not exceed 60 %, with a minimum score of 2.7 registered in Intellectual capital, equal to 45 % of average compliance compared to what was expected by the Framework.

In the comparison between 2009 and 2013, all the capitals increase their compliance score. Excluding variations recorded for the Financial and Manufactured capitals—equal to +7 %—the increase of the percentages of compliance for the other forms of capitals fluctuates between a minimum of 11 % in Natural Capital to a 17 % maximum in Intellectual capital, which in 2013 surpassed, even if by just a little, the score obtained by Manufactured capital. The analysis of the reports does not allow us to determine the cause of the significant growth seen in Intellectual capital. This could be ascribed either to a greater sensitivity developed by companies towards this category of information, caused by the introduction of the Framework, or to a greater weight given to this form of capital in the firm's strategies. It is useful to remember that Intellectual capital is one of the most innovative aspects of IR and, with ever-greater frequency, assumes a determining role in the development strategies of many companies⁴.

⁴ IIRC (2013), *Capitals: background paper for < IR >*, p. 8.

In summary, from the overall comparison of the 2009–2013 reports, the aggregate increase of 4.3 points, which corresponds to a change in the compliance score from 58 % in 2009 to 69 % in 2013, comes from a general improvement in the quality of disclosure observed in all the types of capitals provided for by the Framework, and with five informational sources out of seven monitored that register an increase of the percentage of compliance as over 10 %.

Having concluded the analysis of capitals, we report the main results coming from the measurement of compliance related to the content elements in Table 4.3.

The score of 19.3 recorded in the 2013 IR corresponds to a percentage of compliance equal to 55 %, therefore significantly lower than the capitals (69 %). Unlike what was observed in the latter, the results for content elements showed a much wider range of variability, going from 35 % compliance for the business model, to 81 % for the information relating to governance. Only three content elements out of eight exceed the 60 % average compliance score (governance, organizational overview and external environment, risks and opportunities), while none of the remaining five reach an average compliance of 50 %. The lowest average compliance score is associated with the information on the business model. The illustration of the business model is one of the most innovative aspects

Table 4.3 Average compliance score in content elements' disclosure

	n. item	2013		2009		Variation	
		Score	%	Score	%	Abs.	%
Organizational overview and external environment	7	5.1	72	4.8	68	0.3	4
Governance	4	3.2	81	2.9	72	0.3	9
Business model	5	1.7	35	0.6	12	1.1	23
Risks and opportunities	5	3.1	62	2.2	44	0.9	18
Strategy and resource allocation	5	2.4	47	1.2	24	1.2	23
Performance	4	1.8	45	1.4	34	0.4	11
Outlook	3	1.2	41	0.9	29	0.3	12
Basis of preparation and presentation	2	0.7	38	0.1	5	0.6	33
Total	35	19.3	55	14.0	40	5.3	15

Source: our database from a sample of IIRC' Pilot Program companies

of IR. Its presence seems fundamental to considering the report coherent with the guiding principles provided by the Framework itself. Strategic focus, future orientation and connectivity of information—in particular—can be guaranteed only if the report provides a clear description of the business model that allows the reader to understand how decisions, plans and activities of a firm can create value over time, even in the medium/long term. Analysis of the data collected shows that 62 % of the 2013 reports describe the business model through a narrative flow, but only 43 % provide a corresponding graphic representation as well. Finally, although explicitly provided for in the Framework, only 12 firms out of 76 (16 %) make a specific identification of all the key elements (input, business activities, outputs, outcomes) of the business model.

The contents linked to strategy and resource allocation are somehow related to the representation of the business model. In this case, too, the results seem modest, with a percentage of compliance of 47 % compared to what is provided for by the Framework. However, this result hides a high heterogeneity of behaviors. On the one hand, the strategic objectives of the firm were described in 86 % of reports and there are references to the strategies the firm intends to adopt to pursue them in 79 %, thus with very high percentages of compliance. On the other hand, they lack information relating to the time period of reference for goals (present in 21 % of reports), ways of measuring results (36 %), and the plans of allocation of resources were identified in only 16 % of the cases. These are the results that contribute significantly to breaking down the overall average result related to this content element. In other words, the firms in the pilot program have no difficulty expressing their strategies and related objectives, while they seem more hesitant to provide information on how they intend to reach them and on the procedures of assessment. These aspects, obviously, besides being characterized by higher levels of complexity, are also the elements that would allow one to really evaluate a firm's (and its management's) performance and its ability to create value over time.

The information also appears rather lacking on the contents related to performance and the organization's expectations about the external environment (outlook). In both cases, however, the low score achieved

is mainly due to the almost complete lack of references to future time. The Framework, in fact, highlights how an IR must present a future orientation and provide information about the ability to create value in the short, medium, and long term. If we analyze the results, 96 % of firms (73 out of 76) present linkage between past and current performance, while none provide indications between current performance and the organization's outlook. Similarly, even though regarding the "outlook" content element, 49 % of firms report their expectations about the external environment in their own reports, only 34 % provide indications on the expected evolution of the future performance of the firm itself. These results are consistent with traditional forms of reporting, where attention to results obtained by comparing them with past is favored, while little attention is paid to the future evolution of the management.

If we compare the results recorded in 2013 with those of 2009, there is a substantial improvement in the quality of information and a greater adherence to the contents required by the Framework, even for content elements. The percentage of compliance of the 2009 annual reports was only 40 %, compared to 55 % recorded in 2013. The increase of 15 %, therefore, is higher than the corresponding variation reported for capitals, 11 %. The most significant percentage variation is seen in relation to the basis for preparation and presentation (+33 %), a result that we can take for granted given that it is not information that is generally provided in traditional reports, while holding particular relevance for an IR. After that, business model and strategy and allocation of resources are the content elements with the greatest increase in compliance score, both to the extent of 23 %. The results confirm that these two items represent the real novelty of IR, given that in the 2009 annual reports they had obtained the lowest scores of adherence to the Framework, with 12 % for business model and 24 % for strategy and resource allocation. The less meaningful increases are recorded in the items related to the organizational overview/external environment and governance (+4 % and +9 %) that already presented excellent results in the 2009 reporting, with an average compliance score of 68 % and 72 % respectively.

Compliance Score and Conciseness Index per Region

In this section we will analyze compliance score and information density ratio by dividing them by the companies' geographic area of origin.

Europe represents the continent with the greatest number of companies (37), followed by Asia (12) and North America (10). The analysis of average compliance score distribution by region shows a certain homogeneity of the results, as we can deduce from the reading of Table 4.4.

Most regions present scores near the average of 62 % in 2013. Only the companies of North America and Oceania did not exceed the 60 % threshold. Asia, with its 12 companies, is the continent with the highest average score, with a percentage of compliance at 66 %, followed by South America at 64 % and Europe and Africa at 63 %. The positive result obtained by Africa can be explained by the fact that all the companies in the sample come from South Africa, a country where the introduction of the King Code of Governance Principles in 2010 basically made the adoption of IR mandatory for all listed companies.

A comparison with the corresponding results of 2009 shows that the most significant growth in terms of compliance was obtained in the reports of the Asian companies that, with an average increase of 12 points, record an improvement of 17 %, followed by the North American companies with +16 % and by those of Oceania with +15 %. In 2009, Europe was the region with the highest level of compliance, at 52 %, but

Table 4.4 Average compliance score for region

	n. report	2013		2009		Variation	
		Score	%	Score	%	Absolute	%
Africa	6	45.0	63	34.0	47	11.0	15
Asia	12	47.3	66	35.3	49	12.0	17
Europe	37	45.6	63	37.6	52	8.0	11
North America	10	40.9	57	29.7	41	11.2	16
South America	7	46.1	64	36.9	51	9.2	13
Oceania	4	39.0	54	27.8	39	11.2	15
Total	76	44.9	62	35.3	49	9.6	13

Source: our database from a sample of IIRC' Pilot Program companies

in the period under review it was also the continent recording the most moderate growth rate, with an average increase of only eight points, equal to a +11 % from 2009.

We conclude the presentation of our research data by illustrating the distribution of information density ratio—an indicator that measures the points per page recorded for each report, introduced in section “Overall Findings”—in relation to the company’s region (Table 4.5).

In 2013, the companies of the new continent (Oceania) feature an average value of information density ratio of 0.74, that is, more than double the average score recorded in the sample, 0.35. The companies of North and South America also have a good level of conciseness, with scores of 0.5 and 0.47 respectively. This result is particularly interesting when one considers that Oceania and North America had the lowest scores in the evaluation of compliance in absolute terms (see Table 4.4). This means that these businesses managed to condense a good amount of relevant information in a relatively smaller number of pages. However, while the North American firms improved their information density ratio by virtue of an increase in compliance, it is interesting to note that, for the companies from Oceania, significantly reducing the number of pages in the 2013 reports, compared to the 2009 ones, constitutes the main cause of the increase of this indicator.

If we extend the analysis to the entire sample, the results show an improvement in all regions for this indicator, a sign that the average quality of relevant information per page has increased. It should be noted that Europe is the only continent where the average number of pages increases, going

Table 4.5 Points-per-page indicator by region

	n. report	2013		2009		Variation	
		Score	Pages	Score	Pages	Score	Pages
Africa	6	0.34	135.2	0.21	202.5	0.13	−66.7
Asia	12	0.31	177.3	0.24	183.8	0.07	−5.5
Europe	37	0.25	244.6	0.22	220.9	0.03	+23.7
North America	10	0.50	107.9	0.44	106.2	0.06	+1.7
South America	7	0.47	59.5	0.33	100.5	0.14	−41.0
Oceania	4	0.74	128.1	0.47	206.4	0.27	−75.7
Total	76	0.35	186.9	0.27	190.8	0.08	−3.9

Source: our database from a sample of IIRC’ Pilot Program companies

from 220 to 245, significantly compromising the increase of the information density ratio that improves only by 0.03 points per page, putting it at the bottom of the ranking with an average score of only 0.25 points. North America also shows a slight increase in the average number of pages in their reports compared to 2009 (+1.7 pages), Nevertheless density ratio increases from 0.44 to 0.50 in 2013, confirming the second place in the ranking but in both years under review, the reports remain relatively synthetic, at slightly over one hundred pages. On the other hand, the reduction of the pages of South African firms seems rather significant. In only 4 years, the companies reduced the size of their reports by an average of 66.7 pages, a symptom of a heightened sensitivity to the guiding principle of conciseness.

South American companies, ultimately, manage to obtain excellent results on both the indicators analyzed above, ranking second for compliance score (64 %) and third for information density ratio (0.47), very near the firms of North America (0.50).

Conclusions

The results described in the preceding pages allow us to make some reflections on the objectives underlying our research.

The process of adjustment from traditional reporting to IR has certainly started. The data confirm the firms' commitment to increase the level of adherence to the Framework, both regarding capitals as well as content elements. These results, however, are still not enough to make a completely positive judgment on the tendency of companies to provide an integrated report, and therefore fully embrace the spirit and philosophy provided by the IIRC. If we observe the distribution of scores on the items studied in our research, an attempt to adopt IR more from a quantitative/formal than a qualitative/substantial point of view seems to emerge. This view seems to be supported by the following considerations.

The literature has highlighted the excessive length and complexity associated with traditional reporting. IR, in light of the provisions of the Framework, should be a new model of reporting able to overcome such limits, by virtue of the guiding principle of conciseness. On this front, the results show behaviors very inconsistent from region to region in the 2009–

2013 comparison. Although Africa, South America and Oceania seem to have chosen the right path, with a significant increase in the information density ratio, European companies record the worst result on this front, actually increasing the average number of pages, partly negating the increase in compliance registered in the calculation of information density ratio.

This result is influenced by the structure with which IR was adopted. Those who prepared a separate IR from the annual report (16 companies) obtained a decidedly higher information density ratio compared to those that chose other forms of reporting. This solution was chosen by five out of six African companies, while only one European company out of 37 chose this method of preparing the IR.

A second major limit of traditional reporting concerns the lack of connection between financial and non-financial information. IR, also in this case, should overcome this limit through integrated reporting of all meaningful elements (not only financial) capable of explaining to the stakeholders how the creation of value happens. On this front, the research findings are not univocal.

The analysis of capitals in the 2013 reports allows us to make an overall positive judgment. Although financial capital gets the highest average compliance score—in line with the predictions—even the other (non-financial) capitals reach significant results on the contribution provided in the company's value creation process. However, in the reports analyzed, the illustration of the mutual links between capitals and the role they cover still seems lacking in the theoretical underpinning for the concept of value creation for which the Framework requires identification. This limitation in the respect of the connectivity guiding principle is confirmed by the difficulty in representing the connection between strategy, business model and financial results, given that, in the analysis of content elements, the lowest scores are found in the correspondence of evaluation items related to business model, strategy and resource allocation.

Ultimately, IR should be a possible solution for the lack of forward-looking information in traditional reporting. While traditional reporting is prevalently oriented towards an analysis of the company's past and present results, IR should provide information on the company's methods of value creation with a perspective towards the future, in the medium and long term. It is probably this aspect that received the greatest criti-

cism in the research findings if we consider that the indicators oriented toward the future are those that obtain, on average, the lowest scores in the evaluation of capitals, together with those aimed at measuring value created (with the obvious exception of the indicators related to financial capital). Similarly, the “outlook” content element has one of the worst scores, with a value of 41 %. A somewhat negative judgment on the future orientation, however, comes from the interpretation of the results of many other content elements, as we observed in section “[Content Elements and Capitals: Analysis of Empirical Results](#)”. The information related to the referenced time period of the objectives (content element “strategy and resource allocation”) are presented only by 21 companies in the sample, and none of them provide integrated indications between current performance and the organization’s outlook in the section dedicated to performance analysis.

In summary, the 2013 reports look more like traditional annual reports that are “integrated” with a whole series of informational contents projected by the Framework, rather than an IR in the truest sense of the term. Not surprisingly, the items with the lowest scores coincide with most innovative ones, in line with the “turning point” desired by IR in terms of breaking with traditional reporting practices.

The research findings highlight a certain resistance from the companies that participated in the pilot program to adhere to the spirit of integrated reporting, although the judgment of overall compliance should be considered positive both in absolute terms, as well as in relation to the 2009 results. This behavior of the companies may be justified by different explanations that we are unable to test with the information at our disposal:

- first of all, the fear of revealing information thought to be sensitive and capable of partly compromising its own competitive advantage (for example, concerning future strategies and expected performance of the company, information requested by the Framework and normally absent in traditional reporting);
- second, the fact that important or radical changes (also on the reporting front) require time. The 2013 IRs in our sample were prepared only a few months after the publication of the Framework;

- finally, the lack of prescriptive elements and detailed information in the Framework provides management with wide margins of discretion. Initially, management probably chose a soft adoption of IR, waiting to see the model's future developments and their competitors' behavior as well.

The analysis of these points, which would require a direct comparison with the members of management of the pilot program companies, could be a further research development in this field.

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5

Integrated Reporting: Precursor of a Paradigm Shift in Corporate Reporting?

Richard Barker and Timotius Kasim

Abstract This chapter examines the paradigm underlying the emergence of Integrated Reporting (IR), and its relation to the two divergent paradigms underlying current corporate reporting practice, consisting of financial reporting and sustainability reporting. The chapter utilises the Kuhnian definition of paradigm, consisting of shared axioms, shared commitments, shared values, and shared exemplars. The data analysed include recent IR literature, thus this chapter simultaneously presents a contemporary literature review of IR. The analysis unpacks the underpinnings concerning the language, beliefs, identity, and exemplars perpetrated in the IR literature. It also shows that IR shares the same paradigm with financial reporting, but not with sustainability reporting. Yet, the analysis does not demonstrate paradigm shift in the corporate reporting field, but rather shows the existence of two competing paradigms.

R. Barker (✉) • T. Kasim
Saïd Business School, University of Oxford, Oxford, UK

Introduction

A new paradigm seems to be emerging embryonically in the corporate reporting field; Integrated Reporting (IR) offers a novel form of corporate reporting intended to integrate social and environmental impacts of companies in one report (Eccles and Krzus 2010). Such a paradigm appears to be in contrast with the two pre-existing yet divergent paradigms in extant corporate reporting practice that maintain the distinction between sustainability reporting (SR) and financial reporting (FR). While FR maintains a specific focus on reporting financial capital, SR becomes the platform for reporting multifarious social and environmental aspects of companies. IR, in contrast, seems to draw from both FR and SR in offering a novel paradigm for integrating the financial implication of social and environmental issues into the core reporting system of companies. However, the characteristics of this apparent shift and its distinction with the pre-existing paradigms are not entirely apparent at first glance. The two interrelated purposes of this chapter are to unpack the nature of the paradigm underlying IR and to contrast it with that of SR and FR.

Today, the corporation is increasingly expected to be accountable not only for its financial capital but also for broader social and environmental impacts (Busco et al. 2014; Rowbottom and Locke 2016). This is in part a growing acceptance of social responsibility but also a direct consequence of intensifying social and environmental regulation across the globe (Eccles et al. 2015a), which brings the risk that ignoring the social responsibility trend could harm shareholder value directly. As a result, SR has been growing in both amount and importance relative to that of FR (Beattie and Smith 2013). Yet, the existence of SR as a separate reporting risks obfuscating rather than improving both financial and social and environmental performance of companies, either because it suggests conflicting or confused corporate objectives, or else because SR is in some way represented as non-core to the business (Eccles and Serafeim 2013b). It is in response to this difficulty that the concept of IR has emerged, with its explicit purpose being to broaden the

reporting of value creation so as to extend beyond FR and account for the firm's non-financial capitals (Busco et al. 2013). The shift in focus is argued to allow the integration of social and environmental impact of companies through the identification of the 'business case' arising from addressing negative social impacts, a simple example of which would be the reduction in energy bills arising from decreasing carbon emissions (Eccles and Serafeim 2013a).

This 'middle ground' approach does not entirely share the same mindset associated with SR, which also embraces the possibility of trade-offs, in that the pursuit of improved social and environmental performance might imply forsaking financial profitability (Gray 2010). In contrast, the emphasis of IR on the financial elements of non-financial issues seems like a natural extension to FR in a sense that the primacy of financial capital need not compete with the maintenance of the other capitals—manufactured, human, intellectual, social and relationship, and natural (IIRC 2013). However, despite the similar orientation of IR and FR on delivering shareholder value, the concepts introduced in early IR codification such as the International IR Framework seem to be bring major challenges to the accounting community to think differently in measuring and reporting a broader range of capitals, and to do more than just adopt SR but also to *integrate* a new way of thinking about sustainable value creation (Eccles et al. 2015a). In what way does the emergence of IR suggest paradigmatic change to the corporate reporting field? The aim of this chapter is to investigate this issue by addressing the core underpinning of IR and its relation to that of extant corporate reporting practice in SR and FR. The analysis adopts a Kuhnian definition of 'paradigm' to elaborate the paradigm of IR through examination of the literature on IR. We describe the applicability of a Kuhnian 'paradigm' for our analysis in section "Exploring Kuhnian Paradigm in Corporate Reporting", then we proceed to offer our analysis and arguments in section "Competing Paradigms in Corporate Reporting", before setting up the final remarks of the study in section "Final Remarks: Paradigm Shift in Corporate Reporting?".

Exploring Kuhnian Paradigm in Corporate Reporting

The Genesis of Integrated Reporting

Although the IIRC was only established in 2010, the practice of non-financial reporting can be traced back at least to the period of the 1970s (Owen 2013). Along the way, non-financial reporting practice has garnered significance as a part of corporate reporting, and has attained various labels including corporate social responsibility reports, corporate citizenship reports, sustainability reports, and others. In this chapter, the term sustainability reporting is used as the umbrella term for this type of non-financial reporting practice. The format of SR is quite distinct from the balance sheet, income statement, and cash flow statement of traditional FR, and the sustainability report is often presented separately as if to address a separate audience (Eccles and Serafeim 2013b). Not only that, the Global Reporting Initiative (GRI) Framework, the most prevalent standard for SR, had also been chiefly developed separately by a network of socially responsible investors, the Coalition for Environmentally Responsibly Economies (CERES) (English and Schooley 2014). The unconnectedness of SR and FR eventually led to the development of the accountant's version of non-financial reporting, including the Connected Reporting Framework initiated by The Prince's Accounting for Sustainability Project (A4S) (Rowbottom and Locke 2016).

The scaling up of the Connected Reporting Framework led in turn to the establishment of the IIRC, while gaining the crucial support of the GRI. Therefore, the launching of the IIRC is important not only because it creates an official platform for IR, but also because it symbolically represents the coming together of the investor community (CERES) with the accounting community (represented by A4S). Critically, however, non-financial reporting in this new 'integrated sustainability' form gives strategic importance to the particular type of social or environmental good that coincides with profit. This conception marks a break from SR approach, which stresses the significance of corporate social responsibility, of the pursuit of social and environmental good, as an end in itself

(Gray 2010). This divergence is non-trivial because, as will be argued below, it represents the crux of two incommensurable paradigms to non-financial reporting with the dominant view potentially becoming the reference point for the whole accounting profession.

Kuhnian Definition of Paradigm

In assessing the paradigm underlying IR, we borrow from Kuhn's classic analysis in *The Structure of Scientific Revolution* (first published in Kuhn 1962, latest edition in 2012). Kuhn makes for the case of a paradigmatic framework of scientific enquiry, which is marked by few competing paradigms seeking to explain the cause of natural phenomena; a contradiction-laden paradigm will eventually be replaced by a less contradictory paradigm, which is to dominate the scientific agenda of the research community for some period of time before a better paradigm springs up, marking the perpetual cycle of scientific revolution. Kuhn's idea is fascinating because it systemically explains the instability of what is deemed to be knowledge by observing their commonalities that is the paradigm. Furthermore, it also demonstrates the priority of paradigm insofar as it dictates not only the scientific agenda and ideological commitment of the research community, but also the development of the scientific apparatus which is built around the research programme.

Despite its seminal thesis, the first edition of *The Structure of Scientific Revolution* drew criticism for imprecision in its definition of a 'paradigm'. In response, Kuhn delineated his definition in the postscript to the second edition of the book by distinguishing the two levels of paradigm: 'exemplary paradigm' and 'sociological paradigm'. Kuhn stated that his original intention was to stay at the level of the exemplary paradigm, which is defined as "concrete problem-solutions which, employed as models or examples can replace explicit rules as a basis for the solution" (Kuhn 2012, p. 174). The exemplary paradigm is critical to Kuhn's thesis because it demonstrates the programmatic nature of an academic community in the absence of any manifest rules. The concept of exemplary paradigm is important because it shows the very existence of shared problems in a community is sufficient in orchestrating that community's direction.

In the postscript, however, Kuhn also offered a more nuanced thought, arguing that the exemplary paradigm should not be considered in isolation from the sociological paradigm, which he defined as “the entire constellation of beliefs, values, techniques, and so on shared by the members of a given community” (Kuhn 2012, p. 174). Despite being considered to be ‘philosophically deeper’, the shared exemplar could not have existed independently from the beliefs, values and sense of purpose that constituted the social dimension of the scientific community. In order to elaborate upon this point, Kuhn introduced the ‘disciplinary matrix’, which demonstrated the tandem work of the exemplary and sociological aspects of a paradigm, showing the reflexive relation between the technical aspects of a research programme with the social characteristics of the community. Specifically, the ‘disciplinary matrix’ describes a paradigm in terms of four interrelated components: symbolic generalisations, shared commitments, shared values, and shared exemplars (Kuhn 2012, p. 182).

The first component, symbolic generalisations, refers to the taken-for-granted expressions, which are widely accepted among the community. These expressions represent the ‘laws of nature’, and can be readily found in symbolic form (for example, $f = ma$) or axiomatic words (for example, action equals reaction). Such generalisation is important because it carries a definitional force insofar as it offers a proposition while simultaneously assigning specific definition to the particular proposition. Hence, this component represents the shared linguistic aspect of a paradigm, delineating a boundary for the common problems of a given community. The second component, shared commitments, refers to the belief in a particular model and other related heuristics. The strength of the belief determines the devotion towards a particular research programme or subsequent deviation. The third component, shared values, refers to deeply held values, which determine the identity of a community member. Identity is important because it accords a purpose for the work of the community, giving a sense of importance and exclusivity to the community members.

Finally, the fourth component, shared exemplars, refers to the ‘concrete problem-solutions’ shared by the members of a given community. Kuhn argues that the nature of scientific enquiry is programmatic because members share similar problems or ‘puzzles’. In this sense, knowing the

right problem is as crucial as solving it in determining continuity of community membership. Kuhn proceeds by exploring the socialisation process whereby the 'right problem' becomes introduced to novice scientists through a literal problem-solving exercise during formal education. Such inculcation is argued to allow scientists to export this 'right problem' into another context; hence, in this sense, scientific progress consists of the process of transporting a common problem into various applications (Kuhn 2012, p. 189). This shared exemplar is accorded with a greater salience by Kuhn relative to the three preceding components because it is amenable to being 'concretely' identified historically.

Kuhn's thesis is still relevant to this day because, despite caveating the validity of his theory to the chosen examples (mostly from the field of physics), the underlying explanation of the scientific process can be understood to apply more generally. For instance, in our context, an example of exemplary paradigm in FR would be the problem-solving method for identifying value of a firm through an analysis of financial capital (Suzuki 2003). However, any good accountant would know that financial statements are inadequately equipped to capture the economic 'reality' of a firm in its entirety because of the inherent limitations of a financial measurement system (Burchell et al. 1980; Hines 1988). On the other hand, the emergence of SR practice led by civil society organisations such as GRI seems to represent a quite distinct paradigm from FR, focusing solely on the social and environmental performance of a firm (Bebbington and Thomson 2013). Therefore, the supportive stance of GRI towards the recent emergence of IR initiated by the IIRC is interesting because it suggests development in the paradigmatic structure of the corporate reporting field.

Methods

Against this backdrop, the twofold purposes of this chapter are to explore the nature of the paradigm underlying IR and to draw comparisons with the paradigms that can be said to apply to SR and also FR. Kuhn argues that the emergence of a paradigm is deeply interlinked with the nature of the given community (Kuhn 2012, p. 175). One proxy to gauge the

nature of the particular community would be to examine its literature, hence the analysis is conducted based upon a review of the academic literature, using Kuhn's 'disciplinary matrix' as a theoretical basis for structuring the evidence.

The journal articles are identified from the three main business and management databases: EBSCOhost Business Source Complete, Elsevier SD Freedom Collection, and ProQuest ABI/INFORM Global. The search using a combination of these three databases means that most accounting journals as well as other main business and management journals are covered in the search. The search parameter is based on articles' abstracts in order to narrow down the amount of article hits given the prominence of IR in recent years. The keywords used for the search include: 'integrated report*', 'ir framework', and 'iirc'. The initial search results are filtered further by the reading of the abstract, and subsequently the full papers. The final output yields 35 articles, which are selected based on the centrality of IR in the main discussion of each article (shown in Table 5.1).

The analysis of the papers adopted an interpretive approach in connecting the evidence with the theory. To this end, first, we synthesise the main arguments, key findings, and methodologies of each of the identified articles in order to categorise them based on the specific topics discussed. Then, we proceed to populate the disciplinary matrix with the articles, which we consider to best illustrate the specific component discussed. In doing so, the Kuhnian disciplinary matrix is largely adopted directly, except for the first component, symbolic generalisations. A formalised symbolic logical form is largely non-existent in our context; therefore, in order to focus on the axiomatic words used as a shared language, we replace symbolic generalisations with 'shared axioms', defined as the shared definition of taken-for-granted expression. Hence, the four components adapted become: (1) shared axioms, (2) shared commitments, (3) shared values, and (4) shared exemplars. Altogether, these four components are used as a set of attributes to compare the paradigms underlying IR, SR, and FR in a few separate matrix tabulations.

The analysis begins with the examination of the disciplinary matrix of IR based on the literature identified in Table 5.1. The chapter then proceeds to compare the disciplinary matrix of IR against that of SR and FR. The analysis of the disciplinary matrix of SR includes references

Table 5.1 Literature on integrated reporting

No.	Author(s)	Year	Journal title	Vol.	Article title
1	Adams, C. A.	2015	<i>Critical Perspectives on Accounting</i>	27	The International Integrated Reporting Council: A call to action.
2	Adams, S., & Simnett, R.	2011	<i>Australian Accounting Review</i>	21(3)	Integrated Reporting: An opportunity for Australia's not-for-profit sector
3	Ballou, B., Casey, R. J., Grenier, J. H., & Heitger, D. L.	2012	<i>Accounting Horizons</i>	26(2)	Exploring the strategic integration of sustainability initiatives: Opportunities for accounting research
4	Beattie, V., & Smith, S. J.	2013	<i>The British Accounting Review</i>	45(4)	Value creation and business models: refocusing the intellectual capital debate
5	Brown, J., & Dillard, J.	2014	<i>Accounting, Auditing & Accountability Journal</i>	27(7)	Integrated reporting: On the need for broadening out and opening up
6	Brown-Liburd, H., & Zamora, V. L.	2015	<i>Auditing: A Journal of Practice & Theory</i>	34(1)	The role of corporate social responsibility (CSR) assurance in investors' judgments when managerial pay is explicitly tied to CSR performance
7	Burritt, R. L.	2012	<i>Accounting, Auditing & Accountability Journal</i>	25(2)	Environmental performance accountability: Planet, people, profits
8	Busco, C., Frigo, M. L., Quattrone, P., & Riccaboni, A.	2013	<i>Strategic Finance</i>	95(8)	Redefining corporate accountability through Integrated Reporting

(continued)

Table 5.1 (continued)

No.	Author(s)	Year	Journal title	Vol.	Article title
9	Busco, C., Frigo, M. L., Quattrone, P., & Riccaboni, A.	2014	<i>Strategic Finance</i>	96(9)	Leading practices in Integrated Reporting
10	Churet, C., & Eccles, R. G.	2014	<i>Journal of Applied Corporate Finance</i>	26(1)	Integrated Reporting, quality of management, and financial performance
11	de Villiers, C., Rinaldi, L., & Unerman, J.	2014	<i>Accounting, Auditing & Accountability Journal</i>	27(7)	Integrated Reporting: Insights, gaps and an agenda for future research
12	Eccles, R.G., Krzus, M.P., & Ribot, S.	2015a	<i>Journal of Applied Corporate Finance</i>	27(2)	Meaning and momentum in the Integrated Reporting movement
13	Eccles, R.G., Krzus, M.P., & Ribot, S.	2015b	<i>Journal of Applied Corporate Finance</i>	27(2)	Models of best practice in Integrated Reporting 2015
14	Eccles, R. G., & Krzus, M. P.	2010	<i>Financial Executive</i>	26(2)	Integrated Reporting for a sustainable strategy
15	Eccles, R. G., & Serafeim, G	2013a	<i>Harvard Business Review</i>	91(5)	The performance frontier: Innovating for a sustainable strategy
16	Eccles, R. G., & Serafeim, G.	2013b	<i>Journal of Applied Corporate Finance</i>	25(3)	A tale of two stories: Sustainability and the quarterly earnings call
17	Flower, J.	2015	<i>Critical Perspectives on Accounting</i>	27	The International Integrated Reporting Council: A story of failure
18	Frías-Aceituno, J. V., Rodríguez- Ariza, L., & García- Sánchez, I. M.	2013	<i>Journal of Cleaner Production</i>	44	Is integrated reporting determined by a country's legal system? An exploratory study

(continued)

Table 5.1 (continued)

No.	Author(s)	Year	Journal title	Vol.	Article title
19	Frias-Aceituno, J. V., Rodríguez-Ariza, L., & García-Sánchez, I. M.	2014	<i>Business Strategy & the Environment</i>	23(1)	Explanatory factors of integrated sustainability and financial reporting
20	Fried, A., Holtzman, M. P., & Mest, D.	2014	<i>Financial Executive</i>	30(4)	Integrated Reporting
21	Haller, A., & van Staden, C.	2014	<i>Accounting, Auditing & Accountability Journal</i>	27(7)	The value added statement—An appropriate instrument for Integrated Reporting
22	Higgins, C., Stubbs, W., & Love, T.	2014	<i>Accounting, Auditing & Accountability Journal</i>	27(7)	Walking the talk(s): Organisational narratives of integrated reporting
23	Jensen, J. C., & Berg, N.	2012	<i>Business Strategy & the Environment</i>	21(5)	Determinants of traditional sustainability reporting versus Integrated Reporting: An institutionalist approach
24	Knauer, A., & Serafeim, G.	2014	<i>Journal of Applied Corporate Finance</i>	26(2)	Attracting long-term investors through integrated thinking and reporting: A clinical study of a biopharmaceutical company
25	Lowson, L. M.	2012	<i>Journal of Applied Corporate Finance</i>	24(2)	SEC ESG noncompliance: Where the rubber meets the road

(continued)

Table 5.1 (continued)

No.	Author(s)	Year	Journal title	Vol.	Article title
26	Owen, G.	2013	<i>Accounting Education</i>	22(4)	Integrated Reporting: A review of developments and their implications for the accounting curriculum
27	Parrot, K. W., & Tierney, B. X.	2012	<i>Journal of Applied Corporate Finance</i>	24(3)	Integrated Reporting, stakeholder engagement, and balanced investing at American Electric Power
28	Rambaud, A., & Richard, J.	2015	<i>Critical Perspectives on Accounting</i>	33	The "Triple Depreciation Line" instead of the "Triple Bottom Line": Towards a genuine integrated reporting
29	Reuter, M., & Messner, M.	2015	<i>Accounting, Auditing & Accountability Journal</i>	28(3)	Lobbying on the integrated reporting framework: An analysis of comment letters to the 2011 discussion paper of the IIRC
30	Roth, H. P.	2014	<i>CPA Journal</i>	84(3)	Is Integrated Reporting in the future?
31	Rowbottom, N. & Locke, J.	2016	<i>Accounting and Business Research</i>	46(1)	The emergence of <IR>
32	Serafeim, G.	2015	<i>Journal of Applied Corporate Finance</i>	27(2)	Integrated Reporting and investor clientele
33	Stubbs, W., & Higgins, C.	2014	<i>Accounting, Auditing & Accountability Journal</i>	27(7)	Integrated Reporting and internal mechanisms of change
34	Thomson, I.	2015	<i>Critical Perspectives on Accounting</i>	27	'But does sustainability need capitalism or an integrated report' a commentary on 'The International Integrated Reporting Council: A story of failure' by Flower, J

(continued)

Table 5.1 (continued)

No.	Author(s)	Year	Journal title	Vol.	Article title
35	van Bommel, K.	2014	<i>Accounting, Auditing & Accountability Journal</i>	27(7)	Towards a legitimate compromise? An exploration of Integrated Reporting in the Netherlands

from journal articles, which can be described as a ‘mirror literature’ of SR as their purpose is to solely to articulate critique on the subject of IR from the perspective of SR (these critique articles are also included in Table 5.1), as well as a few journal articles that specifically discuss SR. In contrast, the analysis of the disciplinary matrix of FR is not based upon a comparable, focused literature review. This is not least because of the absence of a ‘mirror literature’ comparable to that for FR, but also it is because the FR paradigm can, in a sense, be taken as given: the centrality of financial capital, profit as a measure of financial performance based upon that measure of capital, and so on, are widely accepted and understood. Given our focus on analysing IR, the references used in the analysis of the disciplinary matrix of SR and FR are meant to be illustrative rather than exhaustive of the entire literature on each respective subject, hence only relevant in the context of this chapter.

Competing Paradigms in Corporate Reporting

Unpacking the Disciplinary Matrix of Integrated Reporting

Starting from Panel A of Table 5.2, we discuss the components of the sociological paradigm of IR.

Despite the absence of any formal logical equation, there appears to be some evidence of shared axioms, including: value and materiality. In this context, value is described to be the function of six capitals: financial, manufactured, intellectual, human, social and relationship, and natural capitals (Fried et al. 2014; IIRC 2014). These capitals are argued to be

Table 5.2 Disciplinary matrix of integrated reporting

	Integrated Reporting	Reference
Panel A. Sociological paradigm		
<i>Shared axioms</i>		
Value	Value is the function of the six capitals	Beattie and Smith (2013); Fried et al. (2014); Haller and van Staden (2014)
Materiality	Financial materiality	Eccles and Serafeim (2013b); Churet and Eccles (2014); Schooley and English (2015); Eccles et al. (2015b)
<i>Shared commitments</i>		
Sustainability spectrum	Integrated sustainability	Adams and Simnett (2011); Busco et al. (2013); Busco et al. (2014); Eccles et al. (2015a)
Corporate strategy	Sustainable strategy	Eccles and Krzus (2010); Eccles and Serafeim (2013a); Eccles and Serafeim (2013b)
Stakeholder engagement	Integrated decision making	Parrot and Tierney (2012); Brown-Liburd and Zamora (2015)
<i>Shared values</i>		
Professional value	Strategic accountants	Ballou et al. (2012); Owen (2013); Higgins et al. (2014); Roth (2014); Stubbs and Higgins (2014)
Reporting purpose	Attract long-term investors	Knauer and Serafeim (2014); Rowbottom and Locke (2016); Serafeim (2015)
Panel B. Exemplary paradigm		
<i>Shared exemplars</i>		
Impact on financial capital	Financial and capital market performance	Knauer and Serafeim (2014); Churet and Eccles (2014); Serafeim (2015); Brown-Liburd and Zamora (2015)
Impact on social and natural capital	ESG (environmental, social, and governance) performance	Burritt (2012); Adams (2015); Parrot and Tierney (2012); Eccles and Serafeim (2013b); Higgins et al. (2014); Stubbs and Higgins (2014)
Impact of regulations	Institutional determinants	Lowson (2012); Jensen and Berg (2012); Frías-Aceituno et al. (2013); Frías-Aceituno et al. (2014)

interchangeable, and thus the value of a firm emanates from the interaction between these capitals, that is the 'value-creation' process (Beattie and Smith 2013). In relation, the concept of materiality is assigned with traditional financial orientation while being broadened to take into account of the financial consequences of non-financial issues, which are also categorised as environmental, social and governance (ESG) issues (Churet and Eccles 2014). The crux of such a definition to value and materiality reflects the continuing primacy of financial capital as it retains its role as the basis for value measurement while also becoming the benchmark for which ESG issues are prioritised in order to identify a profitable avenue of ESG improvement (Eccles and Serafeim 2013b; Eccles et al. 2015b).

The analysis also shows some evidence of shared commitments, including shared beliefs on: integrated sustainability, sustainable strategy, and integrated decision making. In this regard, the beliefs on IR as a reporting model stems from an 'integrated sustainability' approach insofar as the financial impact of non-financial issues would improve the comprehensiveness of the corporate report for the shareholder (Adams and Simnett 2011). In turn, managers would be enabled to make better, more integrated decisions, facilitated by an enhanced reporting system that allowed foresight into financially material ESG matters (Parrot and Tierney 2012). This approach is believed to open the possibility of exploiting 'sustainable strategy', that is the unexplored 'business case' in addressing ESG issues that has been cast aside *hitherto*; in a sense, this is the reinvention of the strategic element of corporate ESG issues (Eccles and Serafeim 2013a).

Next, the analysis also demonstrates some evidence of shared values, including: the profession's strategic ambition and purpose to attract long-term investors. In this regard, IR is considered as an opportunity to galvanise the professional role of accountants to become more involved in strategic matters, thus increasing the standing of the profession as a whole, including those working either as corporate accountants (Ballou et al. 2012; Higgins et al. 2014) or as professional auditors (Owen 2013; Roth 2014). In this light, IR is also considered to add another value to corporate reporting through its potential for attracting long-term investors, given their presumed need for greater disclosure with respect to the long-term consequences of corporate decision-making. Moreover, as long

term investors are by definition less engaged in short-term trading, a further consequence would be to lower the volatility of company's stock market performance (Knauer and Serafeim 2014; Serafeim 2015).

Panel B of Table 5.2 shows some evidence of the exemplary paradigm consisting of the shared exemplar on the impact of the implementation of IR on firm-level performance including: financial performance (Churet and Eccles 2014) and on capital market performance (Knauer and Serafeim 2014; Serafeim 2015), and also improving ESG performance (Burritt 2012; Parrot and Tierney 2012; Adams 2015). Another stream of research assesses the institutional factors and other determinants of IR as to identify the appropriate institutional design for IR adoption (Jensen and Berg 2012; Frías-Aceituno et al. 2013; Frías-Aceituno et al. 2014). These attempts to study IR hinge on the shared puzzle (or 'right problem') that IR has the potential to provide a better corporate reporting system as it enables firms to enhance both financial and non-financial performance simultaneously. Accordingly, the IR literature is built upon this foundation in addressing the impact of ESG issues on financial performance of firms.

Incommensurability of Integrated Reporting with Sustainability Reporting

This section seeks to contrast the four components of the disciplinary matrix between the literature on IR and the literature on SR, which is described to include the 'mirror literature' of SR (those articles written as a critique of IR from the perspective of SR) as well as some conventional articles on SR.

Starting from Panel A of Table 5.3, we begin from the level of the sociological paradigm. The analysis shows the incommensurability of the axioms shared in IR and SR with respect to both value and materiality. The axiom of value in the 'mirror literature' of SR is understood as the inverse function of the natural capital insofar as natural capital is claimed to be situated beyond firm's boundary, and hence its value would be equal to entire accumulated remediation costs, including that which might not yield financial incentive to the firm (Rambaud and Richard

Table 5.3 Disciplinary matrices of integrated reporting vs sustainability reporting

	Integrated reporting	Sustainability reporting	Reference
Panel A. Sociological paradigm			
Shared axioms			
Value	Value is the function of the six capitals	Value is the negative function of the natural capital	Rambaud and Richard (2015)
Materiality	Financial materiality	Natural materiality	Gray (2010)*; Bebbington and Thomson (2013)*
<i>Shared commitments</i>			
Sustainability spectrum	Integrated sustainability	Ideal sustainability	Thomson (2015)
Corporate strategy	Sustainable strategy	Responsible firm	Flower (2015)
Stakeholder engagement	Integrated decision making	Dialogic accounting	Brown and Dillard (2014)
<i>Shared values</i>			
Professional value	Strategic accountants	Social and environmental accounting expertise	Lehman (2001)*; Lovell and MacKenzie (2011)*
Reporting purpose	Attract long-term investors	Maintain stakeholders	van Bommel (2014)
Panel B. Exemplary paradigm			
<i>Shared exemplars</i>			
Impact on financial capital	Financial and capital market performance	'Full-cost' accounting (triple depreciation line)	Rambaud and Richard (2015)
Impact on social and natural capital	ESG (Environmental, Social, and Governance) performance	Societal and ecological footprints	Milne and Gray (2013)*
Impact of regulations	Institutional determinants	Socio-political analysis	de Villiers et al. (2014); Reuter and Messner (2015)

*Non-IR specific literature

2015).¹ The axiom of materiality is also understood differently in the SR literature in comparison to the IR literature as its definition of materiality relinquishes the primacy of financial capital, and prioritises the salience of other non-financial capitals, for example, applying a planetary boundary rather than a corporate boundary in determining the materiality of environmental impact (Bebbington and Thomson 2013). In short, the incommensurability of IR and SR arises here because they do not share the same axioms, instead employing the same terms with fundamentally different meanings.

The analysis also contrasts the shared commitments in IR and SR with the latter shared viewpoints on: ideal sustainability, responsible firm, and dialogic accounting. In contrast with IR, the shared belief in the SR literature represents a notion of 'ideal sustainability', with an orientation towards society and ecology taking primacy over the firm's economic value (Thomson 2015). Hence, the pursuit of corporate strategy becomes that of a responsible firm, which focuses on delivering 'value for society' in an equitable proportion in concordance to shareholder value (Flower 2015). In this regard, managers of the responsible firm are expected to be involved in regular stakeholder engagement, with SR serving as a communicative mechanism between firm and society, in what Brown and Dillard (2014) describe as 'dialogic accounting' (the function of accounting in facilitating dialogue and cooperation between the stakeholders of a firm including methods such as: interactive modelling, scenario analysis, participatory deliberation, and open space methods).

Next, the analysis shows the incommensurability of the values shared in IR and SR with respect to professional value and reporting purpose. Rather than being oriented to enlarge the remit of financial accountants, the paradigm of SR emphasises the importance of developing social and environmental accounting expertise that could be comprehended and deployed by a range of stakeholders (Lehman 2001). In this regard, the development of expertise such as carbon accounting technique is initially

¹ If natural capital is equal to cost of maintenance, then it's inversely related to financial value of a firm because the cost of maintaining the natural capital will come from financial capital of a firm. This general assumption, however, would not hold in a situation where there is a 'business case' for maintaining natural capital. But, a 'business case' would be very hard to find in a non-financially material ESG situation.

considered to be quite separate from the traditional financial accounting methods (Lovell and MacKenzie 2011). In relation then, the function of SR in maintaining stakeholder relationships is considered to be an end in itself with the reporting process facilitating an open communication between the firm and the stakeholders (van Bommel 2014). In this regard, IR and SR also appear not to share the same values in relation to the purpose of the accounting profession with the latter's emphasis on stakeholder's primacy in comparison to IR's focus on investor.

Panel B of Table 5.3 shows the contrasts at the level of exemplary paradigm. The evidence shows that the shared exemplars on SR include: 'full-cost' accounting techniques to calculate the social and environmental cost of a firm (Rambaud and Richard 2015), accounting expertise in measuring the total societal and ecological footprints of a firm (Milne and Gray 2013), and socio-political analysis on the necessary conditions required for SR to be meaningful (de Villiers et al. 2014; Reuter and Messner 2015). This line of literature essentially hinges on the 'right problem' that SR provides a better reporting system as it enables firms to improve the condition of society and ecology as a whole. In this regard, unlike the integrated perspective of IR, SR establishes that society and ecology is located beyond firm's boundary, and hence it is claimed that, "Indeed, a non-financial capital value is not a value but a cost, where money is used as proxy..." (Rambaud and Richard 2015, p. 16). Accordingly, the shared exemplar in the SR literature appears to take an inverse perspective from that of IR as it seeks to address the impact of financial value creation of a firm on the condition of society and ecology in its entirety.

The foregoing analysis shows the contrast in the disciplinary matrix of IR and SR, demonstrating that each share incommensurable language, beliefs, values and exemplars. Incommensurability marks the distinction between competing paradigms with members of each community sharing different viewpoints, as Kuhn puts it, "Two men who perceive the same situation differently but nevertheless employ the same vocabulary in its discussion must be using the words differently. They speak, that is, from what I have called incommensurable viewpoints" (Kuhn 2012, p. 199). Accordingly IR and SR do not seem to share the same paradigm.

Commensurability of Integrated Reporting with Financial Reporting

In this section, we compare the disciplinary matrix of the IR literature against that of FR literature, which is defined to include only a few classic journal articles (such as Barth et al. 2001; Healy and Palepu 2001), which represent the mainstream view of FR given the breadth of the whole FR literature.

Panel A of Table 5.4 shows that the components of the sociological paradigm of IR do not seem to be very distant from that of FR. The classic FR literature considers value to emanate from financial capital (Barth et al. 2001), while the IR literature seems to maintain the assumption while expanding the territory of value to also include other non-financial capitals. Furthermore, Matsumura et al. (2014) exemplifies that the FR literature need not conflict with the IR literature as they showed positive relation between financial and environmental performance, implying the strategic potential of environmental performance given that financial orientation retains priority. In this regards, it seems that the IR and FR literature are commensurable as they share the same axioms.

Next, the analysis compares the shared commitments of the community reflected in the IR and FR literature showing similarities and discrepancies in this area. In respect to the belief on sustainability, the discussion in the FR literature surprisingly resembles the IR literature as the former offering evidence that analysts often attribute non-financial factors in determining the level of 'sustainable earnings', described as earnings after analysts' adjustment to reflect their belief over the core earnings of the firm (Barker and Imam 2010). Moreover, the emphasis for identifying the financial element of sustainability in the IR literature is consonant with the FR literature, which shows evidence of the extreme financial orientation of managers (Roberts et al. 2006). However, there is a slight discrepancy between the IR and FR literature as there is no apparent topic about stakeholder engagement discussed in the FR literature. Based on the analysis, there appears to be more similarities than differences in the beliefs shared in the IR and the FR literature.

Table 5.4 Disciplinary matrices of integrated reporting vs financial reporting

	Integrated reporting	Financial reporting	Reference
Panel A. Sociological paradigm			
<i>Shared axioms</i>			
Value & materiality	Value is the function of the six capitals	Value is the function of financial capital	Barth et al. (2001)*; Matsumura et al. (2014)*
<i>Shared commitments</i>			
Sustainability spectrum	Integrated sustainability	Sustainable earnings	Barker and Imam (2010)*
Corporate strategy	Sustainable strategy	Financial strategy	Roberts et al. (2006)*
Stakeholder engagement	Integrated decision making	–	
<i>Shared values</i>			
Professional value	Strategic accountants	Strategic accountants	Littleton (1949)*
Reporting purpose	Attract long-term investors	Investor's information need	Barker (1998)*; Healy and Palepu (2001)*; Barker et al. (2013)*
Panel B. Exemplary paradigm			
<i>Shared exemplars</i>			
Impact on financial capital	Financial and capital market performance	Financial and capital market performance	Matsumura et al. (2014)*
Impact on social and natural capital	ESG (Environmental, Social, and Governance) performance	–	–
Impact of regulations	Institutional determinants	Institutional determinants	Healy and Palepu (2001)*; Barker et al. (2013)*

*Non-IR specific literature

Next, the analysis commences with the comparison of the shared values in the IR and FR literature. The point asserted on the IR literature regarding the focus on the strategic potential of an accountant in identifying 'sustainable strategy' (Eccles and Serafeim 2013a) seems to be consistent with the view reflected on the FR literature on the professional purpose of accounting described as, "... to aid a person to understand a business

enterprise by means of data.” (Littleton 1949, p. 283). Further, the primary audience for reporting in the IR literature remains to be the investor, a core assumption that remains consistent with the FR literature (Barker 1998; Healy and Palepu 2001; Barker et al. 2013). Hence, in this case, it appears that the IR and FR literature actually share the same view over the identity of the accounting profession.

Then, Panel B of Table 5.4 shows the comparison at the level of exemplary paradigm. The analysis demonstrates that the shared exemplar in the IR literature closely resembles the traditional FR literature particularly on the research surrounding impact of financial capital (Matsumura et al. 2014) and impact of regulations (Healy and Palepu 2001; Barker et al. 2013). There is however a notable gap on the shared exemplar of direct ESG performance in the FR literature. Regardless, the line of research on the FR literature seems to hinge on the ‘right problem’ that FR is the right corporate reporting system as it enables a firm to deliver higher shareholder value. Such a problem closely resembles the ‘right problem’ on the IR literature that is also shareholder oriented, *albeit* applied on broader perspective of sustainability, as if they share the same exemplars.

The shared orientation on shareholder anchors the commensurability of the shared axioms, commitments, values, and exemplars of the IR and FR literature. On this basis, we argue that the IR literature can be seen as an extension of the paradigm underlying FR onto the context of sustainability. In other words, they share the same paradigm.

Final Remarks: Paradigm Shift in Corporate Reporting?

In this chapter, we contemplate the nature of the paradigm underlying the development of IR by analysing the four components of the Kuhnian disciplinary matrix based on the evidence gathered from the literature on IR. Moreover, we contrast the aforementioned paradigm against the two old paradigms in the corporate reporting field: the paradigms underlying SR and FR. The evidence presented demonstrates the incommensurability of IR and SR despite both sharing similar scope on corporate sustainability. On the other hand, the analysis shows that IR and FR share the same paradigm despite some differences in reporting approach.

Figure 5.1 illustrates the paradigms in corporate reporting. The graph locates IR and FR at the same set representing Paradigm P_1 , while SR is located at another set representing Paradigm P_2 , assuming that FR and IR share the same paradigm and the incommensurability of SR with IR and, by definition, also FR. In this respect, the possibility of paradigm shift given the precursor of IR is for Paradigm P_2 to shift towards Paradigm P_1 . Given such hypothetical situation, then the paradigm shift would actually reflect a shift towards the old paradigm, which is, in fact, less alien to the accounting community than that of SR. In other words, the move towards IR would not represent a paradigm shift from the perspective of FR since they are driven by the same paradigm, Paradigm P_1 . However, it would represent a paradigm shift from the perspective of SR insofar as the treatment of corporate sustainability is concerned as Paradigm P_1 reflects a reversion towards shareholder primacy.

The success of a paradigm shift depends on the 'process of persuasion' (Kuhn 2012, p. 199) of converting the rival paradigm. In this regard, we

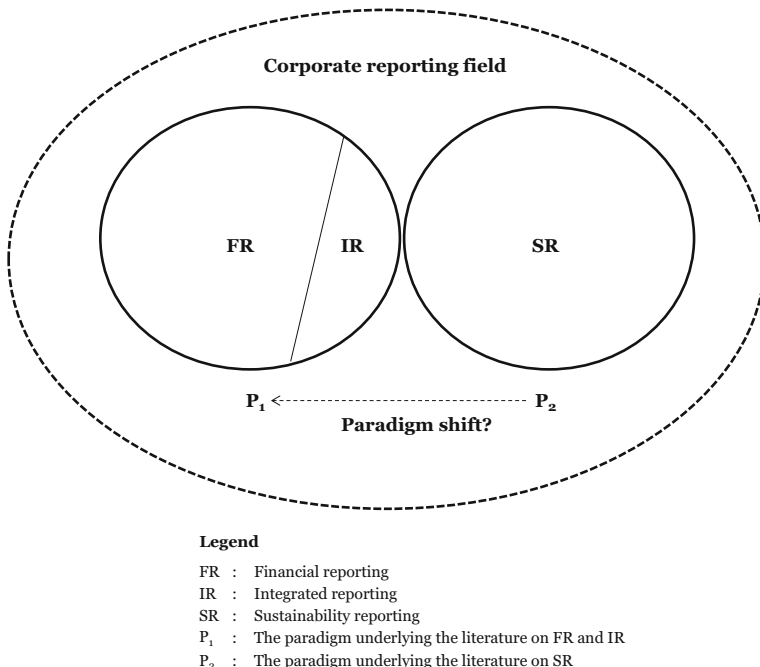


Fig. 5.1 Paradigms in corporate reporting field

argue that the emergence of IR represents the reinvention of Paradigm P₁, which is also driving the FR practice, in order to overcome the competition on the field of corporate reporting posed by Paradigm P₂, which is driving the SR practice. The anecdotal evidence, such as GRI's support over the development of IR, is indicative of a paradigm shift at organisational level. However, the evidence from the literature presented does not seem to be strong enough to indicate the existence of one dominant paradigm. On the other hand, it is apparent that there are two competing paradigms, reflected in the partisanship nature of the accounting academic community on the subject of IR with some taking an extremely critical stance (for example, Flower 2015) while others taking a supportive stance (for example, Adams 2015). Given the purpose of this chapter is to describe rather than to predict, this seems like a satisfactory conclusion.

There are some caveats to our endeavour in some respects. First, while borrowing a Kuhnian notion of paradigm, we do not attempt to predict the direction of paradigm shift in the field of corporate reporting. In this chapter, we simply seek to show the nature of paradigm in corporate reporting, which is tentative, given the relative infancy of IR. Second, we set the limit of our endeavour into the review of academic literature. However, given the intertwinement of the accounting community with practice, the influence of the paradigm can very well extend beyond the literature to shape the 'apparatuses' of accounting practice such as accounting regulations, services, and education. It would be quite interesting to extend the analysis of the paradigm in corporate reporting towards these domains to seek the balance of dominance between the two competing paradigms proposed.

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6

Integrated Reporting: When, Why and How Did It Happen?

José Roberto Kassai and Nelson Carvalho

Abstract Integrated Reporting (IR) may become the twenty-first century revolution in corporate reporting. Traditional corporate reporting concentrated itself in financial reporting and was developed from the first half of the 1900s when most assets were tangible, reflecting in large part the industrialization era. Nowadays we are increasingly living in the knowledge era, and most of the assets of world-class companies are intangibles, or knowledge based (patents, trademarks, software, and similar). Furthermore, capital markets are increasingly looking for firms to generate forms of value creation that go beyond strictly profits: longevity of firms is more and more dependent upon factors like attraction and retention of talent, friendly relationships with neighboring stakeholders, ability to manage and keep personnel satisfied with their jobs, in addition to the ability to raise funds and operate equipment. Information on value creation drivers are required by investors and creditors not only in terms of past performance but also as critical issues for the future sustainability of firms. That is where IR has a vital role to play.

J.R. Kassai (✉) • N. Carvalho
Universidade de São Paulo, São Paulo, Brazil

Introduction

This chapter aims at describing the main facts that preceded the announcement of the first proposal—denominated Conceptual Framework—about Integrated Reporting (IR), approved by the International Integrated Reporting Council (IIRC) at the beginning of December, 2013 and published immediately thereafter.

This chapter also intends to make reference to the content of that proposal, which basically is formed by a set of principles to establish the foundation for this new approach—better described as new philosophy of corporate reporting and derived from the fundamental concept of Integrated Thinking in managing corporations in the twenty-first century.

In a brief comparison in terms of the path leading to genuinely international corporate reporting, the European Union was the first block of countries to converge toward International Financial Reporting Standards—(IFRS) for consolidated financial statements. A number of other countries followed that initiative, and it is reported on the International Accounting Standards Board—(IASB) website that by the end of 2014, about 100+ countries either adopted in full or permitted their companies to elect IFRS as their primary set of financial reporting standards. Among these, Brazil decided to go further and a change in the Company law enacted in December 2007 provided a legal basis for all companies (except banks) to adopt IFRS not only in their consolidated but in their individual—company only—financial statements as well.

This brief review of the recent history of convergence toward an international set of standards helps to clarify the subsequent step, in broad terms, leading to the birth and growth of IR.

Since the first UN World Conference on the Human Environment in 1972, followed by the second such Conference known as “the Earth Summit” in Rio de Janeiro, and the 2012 “Rio + 20” Conference concerns have been raised about how to increasingly involve the business world in the efforts of environment protection and sustainability. (It must be recognized that some pioneer companies started years ago to voluntarily present Environmental, Social and Governance reports and/or to adopt similar measures and disclosures.)

It is remarkable that in the final agreed report of the Rio + 20 Conference, paragraph 47 explicitly recognized the need for governments to stimulate companies to report their actions toward sustainability, as follows: “47. We acknowledge the importance of corporate sustainability reporting and encourage companies, where appropriate, especially publicly listed and large companies, to consider integrating sustainability information into their reporting cycle. We encourage industry, interested governments and relevant stakeholders with the support of the United Nations system, as appropriate, to develop models for best practice and facilitate action for the integration of sustainability reporting, taking into account experiences from already existing frameworks and paying particular attention to the needs of developing countries, including for capacity building”. (The future we want. United Nations. RIO + 20 United Nations Conference on Sustainable Development, 20–22 Jun 2012). The name of the working group is “Friends of Paragraph 47”. It was formed with the aim to give consequences to such paragraph.

For a long time the Global Reporting Initiative (GRI) has been offering—and still continues to offer—valuable suggestions for companies to report their management actions toward financial and non-financial reports, benchmarking their initiatives against a comprehensive set of performance measures.

In the aftermath of the 2008 world financial crisis, concerns grew about developing improvements in corporate financial reporting and also improving non-financial reporting by business enterprises. Several initiatives emerged around the world, and at least three may be mentioned as noteworthy examples from those pioneer days, in the developed as well as in the developing worlds:

- (a) the formation of the IIRC in 2009–2010, under the auspices of the Accounting for Sustainability (A4S) Project led by HRH The Prince of Wales;
- (b) the first “IFRS & GRI Dialogue” in Latin America in May, 2010, which took place at Universidade São Paulo, Brazil, where IR was extensively debated; and
- (c) the establishment of the Sustainability Accounting Standards Board (SASB) in the USA.

SASB

This was incorporated in July 2011 and its Vision and Mission as stated on its website are:

- Vision: SASB envisions a world where a shared understanding of corporate sustainability performance allows companies and investors to make informed decisions that drive value and improve sustainability outcomes;
- Mission: The mission of SASB is to develop and disseminate sustainability accounting standards that help public corporations disclose material, decision-useful information to investors. That mission is accomplished through a rigorous process that includes evidence-based research and broad, balanced stakeholder participation.

First IFRS & GRI Dialogue in Latin America

This consisted of a panel discussion including the international CEO of GRI, the official GRI Representative in Brazil, a representative of the Brazilian Institute of Corporate Governance, the Professor and Researcher in Ethics at the Foundation Institute for Research in Accounting, Actuarial Sciences and Finance—FIPECAFI Research Foundation in Brazil, members of the Brazilian Accounting Standards Board “CPC”, the Professor and author of the book *Value Added as a Separate Corporate Reporting Statement*, and a consultant in Sustainability Reports from The Media Group.

The Dialogue gathered together 177 experts in corporate reporting, with 61 % knowledgeable about the GRI indicators and 39 % mainly specialized in financial reporting.

The results of the Dialogue clearly indicated the need to integrate financial and sustainability reports. As stated by the former President of the University of São Paulo, “Without recognizing the need for a joint effort by accounting and financial reporting specialists, which master the language that markets understand, the environmentalists may find it more difficult to meet the challenge of global climate changes.”

Considering That All Companies Do Prepare Annual Financial Reports and Most of Them Also Prepare Sustainability Reports, Is There a Real Need for Integrated Reports?

Concern about the future of the economy and of countries due to global climatic changes has grown substantially since the United Nations Framework Convention on Climate Change UNFCCC was signed at ECO-92 in Rio de Janeiro. A UN study among its member countries reported that 60 % of individuals believe those changes pose a serious threat, and that 44.5 % agree that human activity is a major cause that directly interferes in these future scenarios.

For the business community, the importance of IR and disclosure of the entity's business model based on a more comprehensive view of the six capitals may seem obvious and not require strong justification.

However, beyond the benefits of producing a report based on Integrated Thinking that is more cohesive and aims at disclosing value creation over time, some other factors justify, in our view, the implementation of IR as a new tool in the corporate communications strategy of corporations, such as the actual composition of a company's valuation and the probable reduction in its capital costs.

Around 1975 the intangible assets of business entities represented around 17 % of the market capitalization of listed companies, while today they account for approximately 84 %. In other words, valuation of companies over time has privileged intangible "capitals," which is precisely the core purpose of IR: to recognize what is effectively contributing to value creation.

Externalities, both positive and negative, strongly influence the intangible value or goodwill of companies, and those that choose earlier to comply with this model of corporate reporting will be more competitive than latecomers that stick to more conventional and traditional reporting (Ocean Tomo 2015).

One Word About IFRS & GRI Dialogue in Latin America

The first event in Latin America that discussed integration of financial and non-financial reporting took place at the School of Economy, Business Administration and Accounting of the Universidade de São Paulo in 2010. The proposal to integrate these two areas was a very sensitive issue.

On the one hand, Financial Reporting has centuries of know-how in handling financial information according to the principle of the “common monetary (financial) denominator.” GRI guidance for preparing sustainability reports are growing increasingly complete as improvements are introduced, encompassing not only financial but social and environmental issues.

The key question is whether IR will nullify or reduce the importance of the reports that already have been prepared by companies? Or even, which of these would become more important?

As a matter of fact, it is not the intention of IR to create a new report or substitute existing reports. The central idea behind IR is to align the information furnished by companies in each of its existing reports, continuing to convey the same message in each and every one of them. Cohesiveness is the target of IR.

Financial accounting is indeed relevant for the economic and financial management of companies, and GRI is fundamental when reporting performance in the financial and non-financial dimensions. None of these reports is irrelevant—on the contrary, they are complementary to each other, but no one achieves IR, which is a long-term vision based on a materiality matrix. By means of such a matrix, IR focuses on what is really essential for a company to pursue the goal of value creation and for its own continuity, understanding that as “sustainability”.

Two of the objectives Integrating Reporting intends to achieve are conciseness and objectivity, allowing interested parties to find relevant information in an organized and more complete way, thereby optimizing decisions about allocating resources and managing companies in an integrated way.

IIRC

In mid-2010 a group of individuals involved both with sustainability and with corporate reporting met in London to discuss the idea of proposing a course of action that could define and promote IR. The press release “Formation of the International Integrated Reporting Committee (IIRC)”—soon after renamed Council, issued by the Prince’s A4S Project in partnership with the GRI, stated that the proposal for creating IR guidelines would be charged to the IIRC.

In the early days IIRC concluded that the best approach would be to develop a Conceptual Framework defining the key areas or indicators that a company should manage and report to show how it created value in the past and how it intended to continue creating value in the foreseeable future. This approach proved to be wiser than the alternative—discarded—to generate a “sample” model of IR. By focusing on the “capitals” or key value creators, IIRC left each company to decide on its model of reporting—narrative, statistical, comparative coefficients or any other. The “form” that corporate reports are integrated is less important than making sure to disclose how the “capitals” or key value creators were and will continue to be managed and reported.

In very simple terms, the core concept is to integrate all existing corporate reports within a company—and NOT to create any NEW report. This means that, for instance, the environment protection equipment a company installs is reported in alignment with any liability provision for Environment Protection Agency fines imposed and disclosed in the financial statements, if any.

Another elementary example of integration has to do with an eventual statement that a company with a large number of employees makes in its “social” report: usually all benefits granted to personnel are described in detail (and with an understandable sense of pride)—but it should be matched with any provisions for labor contingencies arising from disputes with unions or with employees individually, if any. The central idea is that the message should be one and the same in all sorts of reports the company discloses.

The Council met regularly since 2010. In April, 2013 it released an Exposure Draft of the Conceptual Framework and in the beginning of December, 2013, after revising the ED in light of the comment letters received, it released version 1.0 of the Conceptual Framework, available in several languages.

This Framework presents the set of principles that guide the adoption of IR and that are based in the fundamental concept of Integrated Thinking by senior management: the Integrated Thinking leads to a meaningful IR. This concept is based on the idea that integrated thinking allows an efficient and productive capital allocation to ensure not only financial stability and value creation, but also sustainability in the short, medium and long terms.

The six “capitals” that should account for stability and sustainability of a company are: financial, manufactured, intellectual, human, social/relationship and natural capital. Past performance should be reported in all those six “dimensions.” In addition, the sustainability of the business enterprise should be forecast, highlighting the plans to maintain and enhance the six key value creators—and how management plans will avoid or mitigate challenges to each one of them.

In its first part, the Framework presents and comments on the above mentioned six capitals. In sequence, the Framework describes the basic principles and the content elements, as follows.

Basic Principles include strategic focus and outlook, connectivity of information, relationship with stakeholders, materiality, reliability and completeness, coherence and comparability.

Content elements discuss the organization and outside environment, business model, risks and opportunities, strategies and resource allocation, performance, perspectives, bases for preparation and presentation and general guidance about the Integrated Report.

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7

Integrated Report: The Cases of Itaú Unibanco Holding S/A and of Natura Cosméticos S/A

Ricardino Filho and Nelson Carvalho

Abstract For many years environmental problems, caused or aggravated by the existing model of economic development, have generated almost universal concern. Aiming at at least minimizing, if not solving them, several sustainability initiatives are being taken up in various parts of the world. The work of the Global Reporting Initiative (GRI) deserves special reference, due to its role in developing and improving guidance for companies to prepare sustainability reports, presently in its version G4 (GRI 2015). Equally important, the establishment of the International Integrated Reporting Council (IIRC) in 2009 has encouraged the development of corporate reports presenting far more detailed information about current and expected performance. Since then, some companies have adopted Integrated Reporting that complies either with GRI or with the IIRC Framework.

R. Filho (✉)

Department of Accounting, Pontificia Universidade Catolica de São Paulo, São Paulo, Brazil

N. Carvalho

Universidade de São Paulo, São Paulo, Brazil

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Introduction

This chapter describes the reasons that led the Brazilian companies Itaú Unibanco Holding S/A and Natura Cosméticos S/A to disclose Integrated Reports, as well as the internal processes they followed from conception to publication. The first of these companies followed the International Integrated Reporting Council (IIRC) model, while the second followed the Global Reporting Initiative (GRI) approach.

Although these companies follow distinct reporting models and operate in totally different business sectors—Itaú Unibanco is a financial institution and Natura a manufacturer of cosmetics—Integrated Reporting (IR) is supported by the highest levels of decision making in both companies, and it counts on the commitment and involvement of all those responsible for collecting, organizing and summarizing the information to be disclosed to stakeholders.

These companies represent two success stories, and their Integrated Reports are widely recognized as among the best in the world.

The experiences described here are of two Brazilian multinational companies that, although operating in totally different industries, have shared concern with sustainable development, which is publicly stated in their respective Visions and Beliefs:

Vision of Itaú Unibanco: “*Beyond contributing to projecting future challenges, our path allows us to keep growing based on a very clear and objective vision: to satisfy our clients and to achieve a sustainable performance.*”¹

Belief of Natura: “*The company, a living entity, is a dynamic sum of relationships. Its value and its longevity are linked to its capacity to contribute to the evolution of society and its sustainable development.*”²

Although sustainability is one of the common issues of convergence between these companies, that was not the only reason why they were chosen for this chapter. The reason for this choice is due to the fact that their Integrated Reports³ are widely recognized as among the best assessed on a global level, as will be shown ahead.

¹ 2014 Integrated Report of Itaú Unibanco—“Management with a Vision of Future”, p. 7.

² The 2014 Integrated Report of NATURA—“Beliefs”, unnumbered page.

³ The Integrated Reports mentioned here may be found at: <http://www.natura.com.br/www/relatorioanual> and <http://www.ita.com.br/relatório-anual/relato-integrado>.

In this chapter we shall be describing the processes that resulted in the high level of quality and transparency that are found in both Reports. The cases describing the preparation of the respective Integrated Reports are presented below in alphabetic order of each company's names.

Itaú Unibanco Case

Brief History

Unibanco was founded in 1924 under the name of Casa Bancária Moreira Salles (literally “Moreira Salles Banking Institution”, after the name of its founder), and the entity's name was changed in the following years after a number of mergers and acquisitions. The name UNIBANCO was adopted in 1975.

As it relates to the entity's name, Itaú, founded in 1944 as “Banco Central de Crédito” (literally, Central Bank of Credit”) followed a similar track. During its first 26 years its name was changed three times, and finally in 1970 it was formally named “Banco Itaú”.

Additional mergers and acquisitions since then increased the economic strength of each bank and finally, in 2008, they merged with each other and formed Itaú Unibanco, a single banking institution.

Areas of Coverage

According to its Integrated Report (2014, p. 12) the bank is present in 19 countries on four continents, with 5070 branches and service stations for its 57 million clients. Additionally, it provides almost 28,000 automatic teller machines in the countries where it operates.

Business Activities

The data supplied by its Integrated Report (2014, p. 11) informs that Itaú Unibanco is present in four main business segments, with the follow-

Table 7.1 Operating segments

Segment	Net income R\$ million	Total assets R\$ million
Retail banking—commercial	9947	790,785
Wholesale banking	4337	354,212
Retail banking—consumer	3076	108,629
Market and corporation	3259	97,713

ing results in millions of Brazilian Reais (R\$) on 31 December 2014⁴ (Table 7.1):

Retail banking, commercial serves clients—companies and individuals with annual revenues up to R\$ 30 million.

Wholesale banking—This business segment corresponds to investment banking activities serving clients of large corporations.

Retail banking, consumer: This segment provides financing of automotive vehicles outside the network of branches, offers credit cards for non-depositors, and extends credit to employees of firms under agreements for direct payroll deductions of loan installments.

Market and corporation: This business segment manages interest associated to surplus capital, subordinated debt and the net balance of tax credit, among other matters.

During 2014, all business segments together raised funds from depositors and other sources of R\$ 779,284 million, and net income for the year totaled R\$ 21,861 million.

During 2014, the bank informed that it allocated R\$ 52,158 million among the six “capitals” proposed in the Integrated Reporting Conceptual Framework, as follows (Table 7.2):

The distribution of value added was presented according to the classification of capitals proposed by the Framework. The main items included in each “capital” were:

- Financial—comprised of remuneration of third parties’ and of own capital through dividends, interest on own capital, profits for the period and investments in subsidiaries and associated companies.

⁴Just for information, the Exchange rate then was R\$ 2.67 to US\$ 1.00.

Table 7.2 Capital allocation according to IR structure.

Capital	R\$ million	%
Financial	19,090	36.6
Human	15,230	29.2
Social and Relationship	13,770	26.4
Manufactured	2764	5.3
Intellectual	991	1.9
Natural	313	0.6
Total	52,158	100.0

- Human—comprised of personnel expenses (salaries, fringe benefits, bonuses and pension plans) paid to bank employees and business partners. Benefits include training and professional capacity programs and encouraging graduation (doctoral and master degree levels).
- Social and Relationship—Comprised of taxes paid to municipal, state and federal governments, and investments in cultural, educational, and sports projects.
- Manufactured—comprised of acquisition and sale of property, plant and equipment, rent paid and depreciation for administrative buildings, branches and IT data centers.
- Intellectual—comprised of expenditures in the acquisition and development of softwares and new information systems (for back office administration or to attend commercial requirements).
- Natural—comprised of expenses with water, power/light and investments in eco-efficiency.

Institutional Culture

All experience accumulated by the Institution over its more than 90 years of existence resulted in ten principles stated as follows, entitled Our Culture (IR 2014, p. 6):

Our culture is expressed in a set of 10 principles called Our Way of Doing. We reinforce constantly these values with our employees and business partners through events, communication campaigns and performance assessments.

The ten principles are:

- (I) Processes serving people
- (II) Team-player approach
- (III) Shining eyes
- (IV) No short-cuts to success
- (V) Agile and uncomplicated
- (VI) Everything for the clients
- (VII) Dream big
- (VIII) Focus on innovation and innovation with focus
- (IX) Responsible ethical leadership
- (X) Passion for performance

Adherence of Itaú Unibanco to Integrated Reporting

Itaú Unibanco was the first Brazilian financial institution to publish an Integrated Report using the IIRC methodology. The initiative was awarded with the *ABERJE*⁵ prize 2014. Stimulated by that prize, the bank launched a publication in which it reports the learning curve and challenges met in the journey to build up this new philosophy of corporate communication. The remarkable story of how Itaú Unibanco developed this culture is briefly summarized below, based on review of published⁶ and unpublished materials and from interviews with bank employees.

The decision to adhere to IR resulted from a happy coincidence involving four departments of the organization. In 2011 an intern at the Financial Control department was concluding his undergraduate program in Accounting at the University of São Paulo, and as a requirement to conclude his course he had to prepare a monography in a related research area. His supervisor suggested that he write about Integrated Reporting, and it became one of the first studies written about this subject in Brazil.

The student researched the reports released to the public by the Institution where he worked so as to determine whether it could comply with the IR methodology and prepare an Integrated Report. As the

⁵ Brazilian Association of Corporate Communication.

⁶ Information from the Special Publication *ABERJE*, Award 2014. Found at: <http://www.itaun.com.br/relatório-anual/relato-integrado>.

research developed, the senior management at the Financial Control department identified themselves with the project, recognizing its importance and helping to build its momentum.

In parallel, the Investor Relations department was developing a new form of communication with the public in general and with regulators and investors in particular. The project was named Annual Consolidated Report, and it aimed to make the bank accountable to all stakeholders in a sole report contemplating all major communications of Itaú Unibanco (Financial Reports, 20F for the US SEC, Medium Term Notes Debt Prospect MTN, Sustainability Report, Governance Report and GRI Index).

Due to the ample coverage of the Annual Consolidated Report, the teams in the Sustainability and Corporate Communication areas were invited to be part of the project, since they managed staff, processes or the original data and information necessary. In addition, both teams already were familiar with the concept of Integrated Reporting, either by reading or hearing about it.

Aware of the project, the senior staff of the Financial Control department presented the IR concepts with Investor Relations and it was suggested, and accepted, that a specific working group comprised of representatives from a cross section of critical departments in the bank be established to discuss all aspects involved in the different ways to report the bank's activities.

As a consequence of that integration and aiming at enhancing their awareness about the subject, when IIRC held its annual meeting in Amsterdam in 2012, the bank sent two representatives that were part of the working group referred to above. During their stay there, besides assimilating and amplifying knowledge about IR, there was opportunity to talk to regulators, investors and companies that already adopted IR and that defended its content as an ample and transparent approach to reporting. The representatives from Itaú Unibanco came back home totally convinced that was this the way forward.

Upon their return, they started a project to present the IR concepts to the main senior officers of the bank, aiming at getting their approval and acceptance of the organization to this new format of reporting.

Initially, a committee was established composed of up to 17 participants representing the following areas: Financial Control, Sustainability, Investor Relations and Corporate Communication and eventually, when necessary, IT, Legal and Marketing.

According to the special publication for the ABERJE 2014 prize, the starting point was to compare the 2012 Annual Report with the Framework to identify issues requiring adjustments. Once those issues were identified, the Financial Control department was charged with the mission of collecting the information necessary to align the bank's existing Annual Consolidated Report to the concepts of the Framework. In parallel, the proposed adjustments were drafted and submitted to the committee for review and validation.

To assure a harmonious effort among these diverse areas of the bank, Investor Relations asked the areas of Sustainability and Finance to express their information needs. The team of Investor Relations led the process of information gathering at Itaú Unibanco, as the Annual Consolidated Report is more complete and complex than the remaining reports issued by the bank. As a result, the centralization of data gathering led to reliability, effectiveness, control and integrity of the data collected. As a matter of curiosity, this entire process involved over 300 employees and officers of several areas of the bank.

During the process, several challenges of high complexity emerged, among which two were especially notable: disseminating the IR culture, and getting buy-in from several levels of decision-making within the organization.

Identification of the required information was not restricted to the internal environment of the bank. Periodic research was carried out—and continues to be—with external stakeholders to detect information that may be relevant to decision making. In the same way, opinion of representatives of the Analysts Society (APIMEC) was sought about what they considered relevant to be disclosed for the sake of their analyses to provide “buy, sell or hold securities” recommendations to investors.

After identifying all possible information to be disclosed, the committee faced a volume of data far greater than that required for clarity and conciseness. This “problem” resulted in another phase: to identify the

really relevant information that deserved to be in the Integrated Report, which led to a matrix of material issues.

The following step consisted in classifying the data within the six “capitals” of the Framework, with a view toward disclosing them in a structured, concise and connected way.

During the interviews with personnel involved in preparing the Integrated Report, the participants reported some complexity in arriving at a proper definition about what would be the Manufactured Capital of the institution, since it is a Services Entity. The definition included as Manufactured Capital the automatic teller machines, branches, back office installations, service stations and their technology, as well as the technological center hosting the data center, all of which represented investments of about R\$ 11.1 billion (approximately US\$ 3.5 billion) in technology, innovation and services.⁷

The Framework is clear about the treatment of the six “capitals.” As the IIRC instructs, organizations must carry out their appraisals considering the relevance and materiality of the subjects that may impact value creation over time. Once that is done, it is the duty of the organization to define which capitals are relevant in its operational context and which must be reported in the Integrated Report.

One of the reasons why the IR of Itaú Unibanco became such a noteworthy model at a global level was its identification, classification and presentation of all 6 capitals that directly influence shared value creation, each with its relevance level disclosed.

Considering that the bank’s work on its first integrated report started in September 2012 and the publication was in March 2013, it is surprising that in such a short period of time it overcame multiple obstacles and at a surprisingly low cost: about R\$ 192,000 (US\$ 60,000⁸).

Obviously Itaú Unibanco did not always have consensus or certainties about the process of constructing an Integrated Report. When differences of opinions were not settled within the committee, the issues were

⁷Special Publication ABERJE, 2014 Award P. 34 Site: <http://www.italu.com.br/relatório-anual/relato-integrado>.

⁸This figure does not include the cost of working hours of employees because they are fixed costs. It includes basically travel expenses, the sponsoring of joining the IIRC Pilot Program and the costs of auditing.

addressed at higher decision making levels. For that purpose, four levels of analysis were established and are maintained to date (mid-2015):

1st level—Working Group, made up by staff up to the level of middle management;

2nd level—Reporting Committee, made up by Directors and Superintendents;

3rd level—Committees for specific issues;

4th level—Board of Directors.

The 2013 IR was improved and served as a basis for preparing the 2014 IR. The process of improvements is continuous and comes from internal observation and contribution from users and stakeholders.

Awards Won for the Bank's Integrated Report

According to the 2014 Integrated Report, two main awards were won by the bank relating to transparency, relation with investors, and public applause. First, for the 2013 Integrated Report the bank was awarded the ABERJE Prize in the category of Special Publication. Second, the same report was awarded the “Beyond Banking” prize by the InterAmerican Development Bank (IDB). The recognition came in the category Clear Banking, which contemplates successful practices put in place by financial institutions in Latin America and Caribbean countries in managing risks, transparency and corporate governance in the financial sector. This was the first time a Brazilian bank was awarded in this category.

Results Achieved from the Publication of Its Integrated Report

From the standpoint of the organization, five highly positive attributes resulted from the publication of its Integrated Report:

1. Content:

- (a) User-friendly and understandable content, through extensive use of navigation icons/links, charts and infographics to connect each

item with the contents of the Annual Consolidated Report, thereby speeding up search of information by readers;

- (b) Usage and exposure of the concepts of each one of the six capitals as defined in the Framework;
- (c) Clear demonstration of value creation over time with a focus on sustainability and client satisfaction;
- (d) Presentation of future perspectives, targets and challenges.

2. Lessons learned:

- (a) The integration of all different teams involved in each part of the content was a key contributor to the end result;
- (b) Evolution in the governance of information within the organization and in the form the capitals are managed to ensure sustainable performances.

3. Enhancement of reputation:

- (a) The commitment to the IR initiative and the transparency achieved helped in enhancing the bank's reputation and visibility of its brand;
- (b) News giving account of the innovative initiative came out from all relevant media vehicles;
- (c) The hits in the Investor Relations section of the bank's website during 2 months were above 38,000, with a daily average of 418 accesses.

4. Reputation together with opinion makers:

Several voluntary statements about the quality of the bank's Integrated Report came from various parts of the world, including:

- (a) *"A source of inspiration and it establishes a high standard for a good Integrated Report."* Mikkel Larsen, Managing Director & Head of Tax & Accounting Police—DSB Bank, Singapore.

- (b) *“The report guides readers through the material by explaining key definitions and underlying processes.”* Lisa French, IIRC Director
- (c) *“It is one of the best I have seen globally.”* Paul Druckman, IIRC CEO.

Improvements and Future Targets to Be Pursued

The 2015 Integrated Report of Itaú Unibanco is already being planned. For this new edition the bank intends to introduce improvements mainly in two aspects: (i) the format of presentation, and (ii) the integration of the report's contents.

(i) Format of presentation:

- Greater interactivity among the contents of the report and other communication;
- More visual aids;
- Versions on-line and for printing;
- The contents of the report will be presented in the same order as that of the business model, to make navigation easier;

(ii) To enhance the inter-relations and connections within contents of the report itself:

- Revising the matrix of material issues to reveal the limits of the matrix and reassess the classification of capitals (the idea being that material issues do not belong to a single capital classification but result from the interaction of several capitals—each one with its own relevance).
- Reporting the business model in greater detail.
- Increasing the involvement of senior management in the accountability process.

The Natura Case

Brief History

Founded in 1969, Natura was originally named Indústria e Comércio de Cosméticos G. Berjeaut Ltda. Its objective: to sell personal care products comprised of high-quality, natural formulas at competitive prices.

In 1970 the Company's name was changed to Indústria e Comércio de Cosméticos Natura Ltda. In the same decade, it adopted the business model of door-to-door direct sales, which required a personalized contact with its clients. Since its foundation, the Company is committed to high product quality, to principles of sustainability and to respectful work force relations.

Areas Covered

As indicated in the Company's 2014 Annual Report, which provided the source of information for this section, Natura leads the perfumery, cosmetics and hygienic sectors in Brazil. The direct sales model offers economic opportunities to over 1.3 million "Natura Consultants" in Brazil, and to over 400,000 in its international operations—Argentina, Chile, Colombia, France, Mexico and Peru. Local distributors also sell Natura's products in Bolivia. An Australian company in the premium segment, AESOP, was acquired in 2013 and is present in 14 countries with 98 stores, 18 of which opened in 2014.

The profile of the Natura client, as defined by the Company, is a consumer that tries to link aesthetics to health, in a more equilibrated search for beauty.

Financial Profile

In 2014, net revenue from business in Brazil totaled R\$ 6 billion and, according to the consolidated financial statements, amounted to R\$ 7.4 billion including international operations, with growth of 1.9 % in rela-

tion to the prior year. Earnings before interest, taxes, depreciation and amortization (EBITDA) totaled R\$ 1.6 billion, and net income was of R\$ 732.8 million.

Institutional Culture

According to the 2014 Integrated Report, p. 2, Natura's institutional culture is based upon three pillars: reason of being, vision and beliefs.

- *Reason of being*: to create and sell products and services that promote well-being and 'feel well'.
 - Well-being is the harmonious and pleasing relationship of an individual with him/herself, with his/her body;
 - 'Feel well' is an empathetic, pleasurable relationship between an individual and other people, and with the natural world as a whole of which he/she is a part.
- *Vision*: regarding our behaviour as an enterprise involving the quality of the relationships we establish and our products, we shall be a collection of brands with strong presence, local and global, identified with communities of people committed to building a better world, through improved relations among themselves, with other communities and with the natural world of which they are part, and with all that.
- *Beliefs*:
 - Life is a chain of relationships. Nothing in the universe exists by itself, all is interdependent.
 - We believe that perception of the importance of relations is the cornerstone of the great human revolution in valuing peace, solidarity and life in all of its manifestations.
 - The permanent search for improvement is the engine promoting development of individuals, organisations and society.
 - Commitment with truth is the path to quality in relationships.
 - The greater the diversity of parts, the greater shall be the wealth and vitality of the whole.
 - The search for beauty, a legitimate aspiration of every human being, must be free from biases and manipulation.

- A business enterprise, as a living organism, is a dynamic collection of relationships. Its value and longevity are linked to its capacity to contribute to the evolution of society and to its sustainable development.

Adhesion to Integrated Reporting

For the 15th consecutive year, in 2014 Natura presented its Annual Sustainability Report in accordance with GRI Guidelines. During an interview for preparing this section, the person charged with Institutional Communication of Natura, Ms. Jaqueline Nichi,⁹ explained that the presentation of annual information relating to sustainability began after defining the Mission and Essence of Natura in 2000 and developing a methodology for sustainability in 2001, which was presented to stakeholders from 2002 on.

The process chosen at that time followed the trends of disclosing results based upon the IR guidelines recommended by GRI, which aimed at linking financial and non-financial data in the same report, reflecting the business strategy that incorporated all dimensions of the *triple bottom-line* approach of the reporting entity.

This process, like most of first-time initiatives, was time-consuming and required considerable effort, as was acknowledged in a presentation made then by Mr. José Wanderley, Corporate Controller of Natura: “We were approaching information in a new way. Many people had been involved in collecting and presenting data on Key Performance Indicators (KPIs), which we decided to no longer use. It took six to eight months for people to understand what was material.”¹⁰

According to Ms. Nichi, although all three founding partners of Natura give ample support to the subject of sustainability, specifically the partner Guilherme Peirão Leal represents the “sustainability arm” within the Company.

⁹Interviewed by author Álvaro Ricardino on 5 May 2015, at Natura headquarters in São Paulo.

¹⁰The IIRC and Black Sun. have released ‘The Integrated Reporting journey: the inside story’ which looks at the stories behind the research report, ‘Realizing the benefits: The Impact of Integrated Reporting’ published in September 2014. This publication includes interviews with 27 different organizations from around the world. Available at <http://integratedreporting.org/resource/the-integrated-reporting-journey-the-inside-story-2/>.

That identification is not by chance: Mr. Leal, among other initiatives related to sustainability, is founder and member of the Board of the Ethos Institute—of Enterprises and Social Responsibility, besides being on the Boards of WWF-Brazil and of FUNBIO (Brazilian Fund for Biodiversity). He was the Green Party's candidate for Vice-President of Brazil in 2010.

Other members of the organization also share this culture of sustainability. When IIRC—the IIRC—was founded, the former President of Natura, Mr. Alessandro Carlucci, was invited to be a member. The depth of this culture at Natura is evident in Mr. Carlucci's words: "*For anyone who does not like or does not want to practice sustainability, working at Natura is like hell.*"¹¹

This organizational culture is evident in many other ways: Natura signed the Global Pact, a United Nations initiative that encompasses enterprises, workers and civil society in order to promote sustainable growth and citizenship. Natura is also member of the Global Pact's Steering Committee and also endorsed its *Caring for Climate* program.

Development of the Integrated Report

Over the years, the process of collecting data to be transformed into information to users steadily improved. According to Ms. Nichi, the departments of Planning, Sustainability, Investor Relations and Finance get together each year and review the content of the Report with the aim of improving it. Planning avoids duplication of efforts. All participants are involved in defining the directives related to content, which are then passed on to those areas responsible for supplying the data necessary to prepare the Annual Report.

Although the Board of Natura is the key supporter of the Report, Ms. Nichi characterizes its preparation as a transversal initiative, since it directly or indirectly involves almost all sectors of the Company.

As part of this continuing effort to identify which issues require improvement, internal and external research is carried out to reveal criticism and suggestions that are taken into account in the planning meeting.

¹¹ Excerpt of an interview related to the NATURA essence, found at https://www.youtube.com/watch?v=_Spv5Lq4Iqk.

According to Ms. Nichi, this is a long lasting and work-intensive phase, because the collection of data is extensive and requires careful selection of what will be included in the Report and what will be disregarded.

The 2014 Integrated Report

The Company's 2014 report was made available both in a summarized printed version and via web. The Company's performance is presented from financial-economic, social and environmental perspectives.

The *2014 Annual Report—Book of GRI Indicators* contains 99 pages. Its content presents the Natura materiality matrix that sets out six key issues for the Company:

- Residues
- Climatic Change
- Giving value to socio-biodiversity
- Water
- Transparency and origin of products
- Education.

The indicators are divided into economic, environmental and social. The last one is subdivided into labor practices, human rights, society and responsibility for the product.

The materiality matrix deserves special attention. It was defined between 2010 and 2011, by consulting stakeholders both within Brazil and abroad, including employees, suppliers, Natura Consultants, experts in various fields, representatives from the media, and the Company's management. The matrix contemplates the priority issues defining the economic, environmental and/ or social impacts that may relevant to the entity and, as a result, influence the judgements and decisions made by management and stakeholders in general.

Content of the 2014 Report

The complete version of the 2014 Report presents information in ten chapters:

1. About this Report
2. Our Essence, Message from the Founders
3. Message from the Executive Committee
4. Highlights of the Year
5. Natura—Who we are, business model, performance, awards and recognitions
6. Strategy—Business strategy, risks, investments and vision about sustainability
7. Management and organization—Governance, ethics and transparency, government and society, personnel management
8. Brands and products—Innovation, social and biological diversity, water, climate change, residues and transparency and security
9. Our network—Consultants, clients, work force, suppliers and communities
10. Annexes—List of numbers, book of Natura GRI indicators, other publication, assurance report, GRI-G4 summary of content.

The Company issues a 36-page summary report that reproduces the information considered essential for those who may wish to be briefly informed about its main events in 2014.

The content of the main report is subdivided into 25 topics. Due to the space restrictions of this chapter, we limit ourselves to listing their respective titles with a capsule description of their content:

1. Index
2. Direct communication—the integrated view of the multiple angles of the Company's life
3. Our essence—reason of being, vision and beliefs
4. Conquests and challenges—the 2014 achievements and the performance indicators of 2014 to be surpassed in the future
5. Commitment to life—message from founders alerting to the shortage of renewable resources in general, and of water in particular
6. Our contract with society—message from the executive committee
7. The well-being enterprise—brief description of the main areas the company operates in Brazil and abroad
8. Business model—a summary of the model's phases in terms of conception of products, raw materials, suppliers, internal processes, logistics, commercial model and consumption

9. Shared value creation—a summary, in figures, of Natura’s performance in Brazil and abroad
10. Continuous monitoring—a listing of the major risks inherent to the business and actions to monitor and mitigate them
11. A new level of client services—a report on investments in logistic infrastructure and digital technology
12. Think positive impact—the Company’s vision of sustainability, and its strategic targets for 2050 and ambitions to be achieved by 2020
13. Ethics and transparency—an account of the Company’s voluntary compliance with the Sarbanes-Oxley Act
14. Governance—the Company’s commitments to sound governance practices and its future strategies
15. Education with greater fairness and solidarity—the achievements of the Natura Institute and its source of funding
16. Personnel management—how Natura trains its workforce and transmits the Company’s values and culture
17. Cultural aspects—sponsorship of actions involving music
18. Innovation—how Natura conceives of its products in a sustainable way
19. Collective learning—the innovative aspects of the Company’s new commercial products
20. The journey of the EKOS soap products from the Amazon—the various phases of their production, distribution and sale
21. Ecoefficiency—a presentation of the thinking behind production of recyclable and recycled items
22. A powerful social network—the network of consultants that sells Natura products directly in the homes of the Company’s clients
23. Capacity building explore the virtual world—Initiatives involving training of personnel
24. Constantly closer—virtual interaction between clients and the Natura consultant using a tool named CRM—Customer Relationship Management
25. Growth through learning—the Natura approach to searching on-line for a biologically diverse array of raw materials to meet the needs of its supply chain

To summarize Natura's efforts in preparing the 2014 Report, we cite some conclusions from a master's thesis (Maciel 2015, p. 143¹²), which analyzed the Integrated Reports of eight Brazilian companies, including Natura. This study aimed to "...investigate how Brazilian companies are complying with the requirements of IIRC Framework in their 2014 Reports—the first year after the Framework came into effect."

The conclusion indicates that:

Natura managed, with the evolution of its Integrated Reports, to report in a transparent way its results and its commitment to sustainability.

It is noteworthy that the Company improved its ability to communicate, and it is clear that this improvement resulted from integrated management, processes and sustainable strategies adopted by the Company. The financial and non-financial information is reported in an integrated way, revealing the integration of the departments(...).

...It may be concluded that the Company discloses clear information about how the continuous availability, quality and accessibility of the most relevant capitals contribute to its capacity to achieve its strategic objectives in the future and to create value.

Finally, it is noteworthy that, according to Maciel (2015, p. 154) Natura complies with 94 % of the IIRC Framework requirements.

Conclusions

No matter how well prepared these two Reports were, it is worth highlighting, on a comparative basis, their distinctive characteristics:

Regarding the form of presentation, Natura builds its Report in line with GRI guidance, while Itaú Unibanco follows in the IIRC standard. Natura has presented its information since 2001, before the IIRC

¹² Maciel, Paula Álvares. *Relato integrado: análise da evolução da estrutura conceitual e sua aplicação nos relatórios das empresas no Brasil*. (Integrated Report: analysis of the evolution of the conceptual framework and its application in companies in Brazil)—Universidade Federal do Rio de Janeiro, Rio de Janeiro, 2015.

standard had been developed. As a result, any change in the criteria adopted by Natura requires intensive adjustments and leads to a lack of comparability over time, at least during a given transition period. In contrast, Itaú Unibanco's first Integrated Report was based on 2013 calendar results, when IIRC Conceptual Framework was already available. Consequently, the bank could more easily adjust to subsequent changes in the Framework's reporting guidelines.

It should also be observed that, in both cases, the decision-making process to prepare such reports followed a "top-down" approach. In the case of Natura, such an approach could be expected given the beliefs of the company's founders and its business model, which is strongly based on environmental values/protection measures. This is not exactly the case for entities operating in the banking sector, but Itaú Unibanco demonstrated concern with improving its relations with stakeholders interested in its performance and targets and found in the Framework an adequate vehicle to achieve that goal.

It may also be relevant to realize that, due to the different sectors in which these two companies operated, emphasis on financial performance is greater in the Integrated Report of a financial institution than in that of a company using raw materials derived primarily from natural products. On the other hand, Itaú Unibanco has only published two Reports, which may not have been sufficient for a 100-year-old bank to progress substantially beyond basic financial information toward broader accountability of its management.

Natura's focus on environmental protection provides a natural incentive for it to commit to long-term targets and report on them in its Integrated Report. In contrast, long-term targets that correspond to type of "capital" are not fully noted in the Itaú Unibanco Integrated Reports; this may be one of the issues requiring improvement in future reports.

Finally, although the Integrated Reports analyzed herein present, in their own ways, information of high and well-recognized quality, it is perhaps too early to state that Integrated Reports will be widely adopted by most Brazilian companies. Key Brazilian players, namely four members of the IIRC Council, are actively engaged in pursuing this "dissemination objective." Furthermore, a Brazilian private sector Committee was

established for the purpose of monitoring and disseminating IR in the country, and its membership is increasing.

The evolution of Corporate Reporting along the last century shows that the old approach of “Financial Reporting” only is being gradually superseded by more complete forms of communicating performance and targeted goals to value creation. First it was seen that Environmental Reports started being published. Then, Social and Governance Reports found their way in the corporate communication world. And finally IR comes to defend the idea that the messages in all these reports must be aligned and harmonized, for the purpose of them all passing on to users the same and sole information about past performance and future perspectives. As a result, IR inaugurates a new perspective for what may be considered “Sustainable Business Enterprise”: simply put, it is the enterprise that was able to create value in the past, shows good prospects of keeping creating value in managing properly its “capitals” in the foreseeable future and represents a long-lived expectation of being kept in business—this is what may be understood as “sustainability in its broad sense”.

Considering all the aspects commented above, IR may have a more satisfactory future only if the senior leaders of the business community, in Brazil and abroad, realize that (i) an Integrated Report is a more intelligent tool to communicate about enterprise sustainability in its broad sense, and (ii) transparency in reporting past performance and disclosure of targets is beneficial not only to the company but to humanity as a whole, enabling the business community to award future generations with something better than scarce resources.

Reference

Maciel, Paula Álvares. 2015. Relato integrado: análise da evolução da estrutura conceitual e sua aplicação nos relatórios das empresas no Brasil. (Integrated Report: analysis of the evolution of the conceptual framework and its application in companies in Brazil)—Universidade Federal do Rio de Janeiro, Rio de Janeiro.

8

The Influence of Institutional Investors on Companies' Disclosure

Marco Fasan

Abstract This chapter focuses on Integrated Reporting (IR) and institutional investors, which are arguably one of the main audiences for IR. In particular, it tests whether institutional investors engaged in activism aimed at pushing companies to join the International Integrated Reporting Council Pilot Program and whether membership in this program has attracted institutional investors. The reasons underlying our hypotheses are connected to the (expected) increase in companies' disclosure quality and in management's orientation toward the long-term. The two hypotheses were tested on a sample of 156 companies, over the 2010–2014 period. Our preliminary empirical results disconfirm both our hypotheses and we argue that further research is necessary, specifically regarding the short and long-term orientation of institutional investors internationally.

M. Fasan (✉)

Department of Management, Ca' Foscari University of Venice, Venice, Italy

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Introduction

According to the International Federation of Accountants (IFAC) (2014), environmental, social and governance information is increasingly being used by investors to understand an organization's key ESG factors and how they impact overall performance over a longer time span. In this context, Integrated Reporting (IR) may play a central role as a vehicle of non-financial information that is often important in assessing companies' future long-term performance. The International Integrated Reporting Council (IIRC) seems to strongly believe in such a role for IR, as it defined long-term investors as one of the main audiences of IR (IIRC 2013) and has launched its Investor Network.

There are two main reasons at the base of the relationship between IR and institutional investors.

First, IR may help reduce the information asymmetries between managers and investors. IR aims at providing material information crucial for investors to understand the future ability of a corporation to generate value. Lower levels of information asymmetries in turn facilitate and reduce the cost of access to finance for corporations (see Hubbard 1998; Merton 1987) and lower the cost of monitoring and activism (see Healy and Palepu 2001).

Second, IR may increase (or mark) a reporting company's long-term orientation. Internally, IR helps managers collect information and data that are useful in orienting them toward the long term. For instance, assessing the issues that will materially affect the future performance of a corporation is a central activity both for the purposes of IR and for effective long-term management. Externally, IR signals the long-term and sustainability orientation of a company to institutional investors. As argued by Knauer and Serafeim (2014), "reporting a company's strategy, external environment, performance and prospects in an integrated way has the potential to showcase management's commitment to operating in a sustainable and responsible way".

This chapter investigates the interrelations between IR (or more specifically: the participation in the IIRC Pilot Program) and institutional investors. First, it hypothesizes that institutional investors pushed their

companies to join the IIRC Pilot Program. This form of institutional investor activism is justified by the expected benefits for the companies in joining the IIRC Pilot Program. Second, it hypothesizes that companies that joined the IIRC Pilot Program are able to attract institutional investors to a higher extent, because of lower information asymmetries and better long-term orientation.

Our preliminary empirical results show that there are no statistically significant effects of IR on institutional investor shareholdings and vice versa. As will be more extensively discussed below, one possible explanation for our results is that institutional investors are not yet fully aware of or persuaded by the benefits of IR. This evidence confers a central role to the IIRC investor network, which aims to enable investors to provide their perspective on corporate reporting.

Further research is needed in order to assess the impact of IR, not only on institutional investor shareholding but also on the specific characteristics of such shareholding. It may be that IR, on the international level, increases the shares of long term-oriented investors, consistently with what was found by Serafeim (2015) for the US context.

Background

This paragraph provides some background on institutional investors, their impact on corporate disclosure and, finally, on the specific relationship between IR and institutional investors.

Institutional Investors

Over the past few decades, institutional investors have acquired a predominant role in corporations' ownership and consequently in their governance. The role of institutional investors in corporate governance has attracted much attention. In particular, institutional investor activism plays a significant role in this field. A very commonly used definition is the following: "the active investor is the one who tries to change the status quo, showing their contrariety without changes in corporate ownership"

(Strarks and Gillan 2000). Previous studies propose three main reasons for “activism” (i.e. direct involvement) by institutional investors in corporate business. Institutional investors’ willingness to be active may depend on: the firm’s financial results, the type of industry in which the corporation is doing business and the characteristics of the institutional investor itself.

The first reason for activism is financial performance. In the case of negative financial performance and a subsequent drop in stock price, institutional investors are left two choices, to either sell their shares (exit option), or try to change the business strategy of the firm (activism option). Since these entities usually own an amount of shares so significant that the share’s price will decrease once they start selling, the exit option is often not recommended (Strarks and Gillan 2000). This makes the choice of engaging with corporate management, in an attempt to reverse the negative trend, a more appealing possibility.

The second factor influencing institutional investor activism is the industry environment. Relatively calm industries (such as mining, energy and healthcare) that are not affected by frequent changes may lead investors to be less active in controlling the company.

The third motor of activism is the type and relative characteristics of the institutional investors. As institutional investors include a wide range of entities, different categories have different levels of propensity to activism. In order to determine the propensity toward activism, one needs to consider: the holding time horizon of shares, fund dimension, expected performance, relative share of the investor’s portfolio, active or passive management, internal or external management and relative share of corporate holding.

There are several ways for institutional investors to engage in activism. The active investor tries to involve the firm’s management in a discussion of their ideas of change to begin with. If this negotiation does not provide the expected results, the active investor will adopt more formal means. Shareholder activism can indeed be implemented through writing letters, dialoguing directly with the board of directors, making inquiries during the open sessions at general shareholders’ meetings, or possibly presenting official proposals to be voted on in shareholders’ summits. This last, more formal strategy is sometimes the only means that investors have to

bargain with management that generally perceives shareholder activism as something unproductive.

A particular typology of institutional investors are the Socially Responsible Investment (SRI) investors. A basic concept of SRI is shareholder activism, in the sense of engaging investors and then the corporation in social responsibility practices. At the end of the 1970s, the topic of human rights became prominent in the media and in public debate. At that time, some of the biggest American fund managers decided to exclude companies operating in South Africa, where apartheid was still in place, from their investment portfolio. Starting from that time, the financial market witnessed a constant increase, worldwide, in the number of consulting firms specializing in the field of ethics. This segment is now in a phase of rapid expansion, although resources invested in ethical financial instruments are still a minority compared to those in traditional financial mechanisms (Lori Holde-Webb 2009).

Particularly relevant is the United Nations Principles for Responsible Investment (PRI) initiative, which consists in an international network of investors working together to put the six PRI into practice. Their goal is to understand the implications of sustainability for investors and to support signatories in incorporating these issues into their investment decision-making and ownership practices. The principles range from the inclusion of Environmental, Social and Governance (ESG) considerations in the decision-making activity of the institutional investor to the institutional investor's activism to promote sustainability in the firms they hold stakes in.

Institutional Investors and Disclosure Quality

The relationship between firm disclosure quality and institutional investor shareholding has been investigated extensively in previous studies. According to Bushee and Noe (2000), an institutional investor may be sensitive to a firm's disclosure quality for three main reasons. First, as shown by Diamond and Verrecchia (1991), better firm disclosure reduces information asymmetry between firms and investors, with positive consequences for the investors. Second, institutional investors can be sensitive

to disclosure quality if it affects the potential profit opportunities in a firm's stock. In fact, the long-term value of a company may be eroded if the firm's disclosure provides a substitute for private information collection. Third, disclosure quality can be important if companies rely on public disclosures to monitor the firm and determine when to engage in corporate governance activities.

From an empirical perspective, Bushee and Noe (2000) found that firms with higher disclosure quality have greater institutional ownership. Also Healy et al. (1999) reported that sustained increases in disclosure quality resulted in higher levels of institutional ownership, which they cite as a benefit in improving disclosure quality. Tasker (1998) and Bushee et al. (2003) found that firms with higher institutional investor ownership are less likely to have conference calls. This result is consistent with both the intuition that informed investors prefer less disclosure, as well as the notion that analysts and institutions produce information, reducing information asymmetry and the need for conference calls (see Core 2001).

Institutional Investors and Integrated Reporting

The specific research topic of the relationship between IR and institutional investors has been recently tackled in two articles. The first is a work by Knauer and Serafeim (2014), who examine the case of a biopharmaceutical company to show how a company's investor base is likely to change over time when management makes sustainability issues a major strategic focus of the organization and reports its performance in an integrated way. One of the main underlying assumptions of their work is that a company's investor base is not exogenously determined but is rather subject to the influence of management. The authors find that the long-term orientation of investors increased as a consequence of the company's reporting its performance in an integrated way.

Serafeim (2015) tests a similar intuition on a panel data set ranging from 2002 to 2010, featuring US companies for which data on the degree of IR practice were available. He finds that firms that practice more IR have a longer-term investor base. This result is driven by more dedicated

and fewer transient investors. According to the author, there is a causal mechanism from IR to the investor base of the company. Both articles cited above are based on the US context and use the classification of Professor Brian Bushee in identifying institutional investors. According to this methodology, there are three typologies of institutional investors: (i) “transient”, investors holding a high number of stocks, with high turnover and short holding periods; (ii) “quasi-indexers”, those holding a high number of stocks, with little turnover and long holding periods; (iii) “dedicated”, those holding relatively few stocks for long period of time (see Knauer and Serafeim (2014)).

Hypotheses Development

We aim at expanding the current academic literature by studying the relationships between disclosure quality (and, more specifically, IR) and institutional investors. Compared to previous studies, we make use of a more complete and international sample in order to perform our empirical analysis, where the main variable of interest is the participation in the IIRC Pilot Program. We also specifically test both directions of the relationship, as it may be that IR impacts institutional investors, or vice versa.

The first hypothesis tests whether companies with higher institutional investor shareholding are more likely to join the IIRC Pilot Program.

On the one hand, IR aims at improving firm disclosure quality and accountability. It provides investors with more information about the long-term performance of an organization and requires companies to focus on factors such as governance, risk and opportunities, and business model, which are very important in assessing its ability to generate value.

On the other hand, long term-oriented investors are likely interested in more and better information quality about the future long-term performance of the company. Similarly, also short term-oriented investors may be interested in the company producing an IR because this would reduce information asymmetries. Better information on the future performance of the company may allow short-term investors to decide more efficiently whether to hold or sell the stocks they are holding.

We therefore hypothesize that institutional investors encouraged the companies they held shares in to join the IIRC Pilot Program, because they expected the disclosure quality of the companies to increase. In other words, we are testing a particular form of institutional investor activism, aimed at pushing companies toward the implementation of IR and motivated by the expected benefits of IR in terms of improvements to disclosure quality.

We propose the following hypothesis:

Hyp. 1: In the pre-IIRC Pilot Program period, companies that joined the program had a higher percentage of capital held by institutional investors compared to similar companies that did not join the program.

The second hypothesis aims at testing, in line with previous studies (see Serafeim 2015), whether companies that joined the IIRC Pilot Program then attracted institutional investors to a higher extent. In other words, we hypothesize that institutional investors may be willing to invest more heavily in companies producing IR.

There are several reasons that support this prediction. First, as suggested by Serafeim (2015), while research has shown that disclosure of sustainability data has economic effects (see Cheng et al. (2014)), there has been significant criticism of its usefulness for investor decisions. In particular, the most important criticism has been the lack of placing the data in the context of the company's strategy and business model, thereby obscuring the relationship between sustainability and financial performance (see Serafeim 2015; Eccles and Krzus 2010). IR attempts to mitigate these deficiencies and, more broadly, may improve disclosure quality.

Besides, IR may be an indicator of management ability. IR is a state-of-the-art financial reporting practice, and institutional investors may view a management team that is implementing it favorably. IR may also signal long-term orientation, as it requires companies to provide information on future and prospective performance (see the Strategic focus and future orientation principle).

We therefore propose our second hypothesis:

Hyp. 2: In the post-IIRC Pilot Program period, companies that joined the program have a greater increase in the percentage of capital owned by institutional investors compared to similar companies that did not join the program.

Methodology

We test our hypotheses on a matched sample of 154 companies. Half the sample (76 firms) is part of the IIRC pilot program while the other half (76 firms) is not part of the program. They are matched by size and industry.

The main variable of interest is the percentage of firm shares held by institutional investors. This variable is obtained through the Bloomberg database for the years 2010–2014. We divide the sample period into the pre-IIRC Pilot Program (2010–2011) and post-IIRC Pilot Program (2012–2014) sample periods.

In order to test our first hypothesis, we implement a univariate analysis between IIRC and non-IIRC Pilot Program companies. Employing parametric (t test) and non-parametric (Wilcoxon rank-sum) tests, we compare the level of shareholdings. We also divide the sample into financial and non-financial companies. We do this because there may be some significant differences between financial and non-financial corporations, in terms of institutional investor shareholdings and corporate governance.

The second hypothesis is tested through another univariate analysis, testing the change in institutional investor shareholding between IIRC and non-IIRC Pilot Program companies. Finally, we provide a year-by-year comparison of the level of institutional investor shareholding between IIRC and non-IIRC Pilot Program companies.

Results and Discussion

Table 8.1 shows that the mean and median levels of institutional investor shareholding were not significantly different between IIRC and non-IIRC Pilot Program companies in the pre-IIRC Pilot Program period. The mean (median) level of institutional investor shareholding among IIRC companies in the pre-IIRC Pilot Program period is 45.29 % (40.41 %) and among non-IIRC companies, 42.86 % (36.82 %). The two values, according to the t test and the Wilcoxon test, are not significantly different, even though IIRC companies do have a higher percentage of institutional investor holding.

Table 8.1 Institutional investor holdings among IIRC and non-IIRC companies (pre-IIRC Pilot Program period)

	IIRC companies mean (median)	Non-IIRC companies mean (median)	Difference mean (median)	t test	Wilcoxon test
Institutional investors	45.29 (40.41)	42.86 (36.82)	-2.43 (-3.59)	-0.63	-1.28
Institutional investors (financial companies)	40.95 (41.37)	42.44 (31.95)	1.49 (-9.42)	0.15	-0.34
Institutional investors (non-financial companies)	45.88 (40.21)	42.99 (39.66)	-2.89 (-0.55)	-0.67	-0.99

This table shows the results of the univariate analysis. It compares means and medians of the institutional investors shareholding among IIRC and non-IIRC companies in the pre-IIRC Pilot Program period, the null hypothesis being that the means and medians are not significantly different. The tests are repeated among financial and non-financial companies only and results displayed in the second and third rows. Coefficients' significance: * $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$

No differences between the two groups (IIRC and non-IIRC companies) arise, even when we split the sample between financial and non-financial companies. Overall, these results disconfirm our first hypothesis, because, on average, the level of institutional investor shareholding is similar between IIRC and non-IIRC companies.

Table 8.2 displays the results of the univariate analysis of the change in institutional investor shareholdings between IIRC and non-IIRC Pilot Program companies in the post-IIRC Pilot Program period. Our aim here is to test whether companies that joined the IIRC Pilot Program managed to attract investments from institutional investors to a higher extent than other companies. Therefore, we are interested in the change in institutional investor holdings, rather than the level.

The empirical results show that the change has been generally positive, therefore we can say that the trend is for companies to have larger institutional investor shareholdings. Nevertheless, this trend has not been significantly different between IIRC and non-IIRC companies; rather, it seems to be a general market trend. IIRC companies increased their institutional investor shareholding by 11 % (median value: 3 %), while non-IIRC companies increased it by 19 % (median value: 4 %). Both the

Table 8.2 Change in institutional investor holdings among IIRC and non-IIRC companies (post-IIRC Pilot Program period)

	IIRC companies mean (median)	Non-IIRC companies mean (median)	Difference mean (median)	<i>t</i> test	Wilcoxon test
Institutional investors	0.11 (0.03)	0.19 (0.04)	0.08 (0.01)	1.18	-0.44
Institutional investors (financial companies)	0.043 (0.02)	0.20 (0)	0.16 (-0.02)	1.05	-0.16
Institutional investors (non-financial companies)	0.12 (0.04)	0.19 (0.03)	0.06 (-0.01)	0.86	-0.36

This table shows the results of the univariate analysis. It compares means and medians of the change in institutional investors shareholding among IIRC and non-IIRC companies in the pre-IIRC Pilot Program period, the null hypothesis being that the means and medians are not significantly different. The tests are repeated among financial and non-financial companies only and results displayed in the second and third rows. Coefficients' significance: * $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$

t test and the Wilcoxon test show values that are not significant, both for financial and non-financial companies. Overall, this empirical evidence disconfirms our second hypothesis.

Finally, Table 8.3 compares the level of institutional investor shareholdings between IIRC and non-IIRC Pilot Program companies, year by year. We display this analysis in order to determine whether any specific time trends emerge. Macroeconomic conditions change over time, and this may lead to an effect on institutional investor holdings over time. As we can see from Table 8.3, this is not the case, and this evidence further corroborates our results, that institutional investor holdings and IR do not seem to be interrelated.

Overall, our empirical results disconfirm both our hypotheses and suggest that institutional investors did not engage in any significant form of activism in order to push companies to join the IIRC Pilot Program. In the same vein, the increase in institutional investor holdings in the post-IIRC Pilot Program period was not significantly different between IIRC and non-IIRC companies, again indicating that companies engaging in the implementation of IR did not manage to attract more institutional investors.

Table 8.3 Institutional investor holdings among IIRC and non-IIRC companies by year

	IIRC companies mean (median)	Non-IIRC companies mean (median)	Difference mean (median)	t test	Wilcoxon test
2010					
Institutional investors	45.85 (40.59)	41.94 (34.60)	3.90 (5.99)	0.70	1.14
2011					
Institutional investors	44.77 (40.41)	43.75 (37.20)	1.01 (3.21)	0.18	0.69
2012					
Institutional investors	45.04 (40.80)	49.56 (45.79)	-4.52 (-4.99)	-0.87	-0.57
2013					
Institutional investors	52.37 (47.52)	56.54 (52.24)	-4.16 (-4.72)	-0.81	-0.91
2014					
Institutional investors	53.46 (51.16)	57.35 (58.39)	-3.89 (-7.23)	-0.78	-0.86

This table shows the results of the univariate analysis. It compares the mean and median of the institutional investors shareholding among IIRC and non-IIRC companies, the null hypothesis being that the means and medians are not significantly different. Coefficients' significance: * $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$

One possible explanation for our results is that institutional investors are not yet fully aware of or persuaded by the benefits of IR. While the IIRC created an investor network, comprising about 35 global investor organizations, the vast majority of investors may still be in an early phase of awareness of the topic. This is even more relevant if we consider that the main variable of our study was the companies' involvement in the IIRC Pilot Program, and not the actual publication of an IR. As a matter of fact, many organizations, despite joining the IIRC program, did not publish any IR at all. Therefore, we hypothesize that the factors impacting the investment decisions of the institutional investors were both the actual improved disclosure quality (for companies actually publishing an IR) and the expectations of institutional investors about the prospective improvements in information quality (for companies that have not published any IR yet). Clearly, besides these motivations tightly linked

to disclosure, there are other motivations about the increased ability of managers to improve long-term performance and strategic focus.

These empirical results confer even more importance to the IIRC Investor Network initiative, in terms of the diffusion of IR awareness. According to the IIRC, the IR Investor Network enables investors to provide their perspective on needs and directions in corporate reporting. It also provides a forum for articulating the benefits of IR and for advocating for innovations, which meet investor needs in keeping with aligning investment decisions to the wider goals of financial stability and sustainable development.

While other related research articles (Serafeim 2015) focus on the different typologies of institutional investors and on the change in their composition as a consequence of IR, we look at the total institutional investor shareholdings. This is due to the fact that, while the work by Serafeim (2015) focuses on the US context only, our analysis explores the international context, and this presents some challenges in terms of data availability. Nevertheless, future research may investigate changes in shareholder composition for IIRC and non-IIRC companies. It may be the case that the level of institutional investors did not change after involvement in the IIRC Pilot Program, but the composition did, perhaps increasing the share of long-term investors, consistently with what was found by Serafeim (2015). Similarly, future studies may find that companies that joined the IIRC Pilot Program did have a higher percentage of long-term (or “dedicated”, using Bushee’s classification) investors, thus providing evidence toward the IR activism hypothesis.

Conclusion

This chapter has focused on the relationships existing between institutional investors and IR. In particular, it has tested whether institutional investors pushed companies toward joining the IIRC Pilot Program and whether the increase in institutional investor shareholdings was higher in companies that were part of the program compared to similar companies that were not. The reasons underlying our hypotheses are connected

to the (expected) increase in companies' disclosure quality and management's long-term focus.

The two hypotheses were tested on a sample of 156 companies, over the 2010–2014 period. Our preliminary empirical results disconfirm both hypotheses, conferring an even more key role to the IIRC Investor Network, which aims at enabling investors to provide their perspective on corporate reporting. The analysis adds to the existing literature on the relationship between IR and institutional investors (see in particular Serafeim 2015).

Our preliminary results suffer from two main shortcomings, which can be overcome by future research. First, our sample covers the 2010–2014 period and it is thus fully impacted by the financial crisis. On the one hand, some may argue that the focus on sustainability and long-term orientation was increased following the financial crisis, leading to the expectation that IR would play an even more central role. On the other hand, we argue that the market values of companies during the crisis may have led some investors to purchase or sell shares because of reasons totally unrelated to disclosure quality and IR. For instance, some companies may have had a relevant increase in institutional investors' ownership because of a steep drop in their stock price.

The second shortcoming is linked to the international nature of our sample, which does not allow us to define the orientation (short- or long-term) of institutional investors. This implies that IR may have had an impact on the temporal orientation of institutional investors but not on the total of institutional investor shareholdings. If this is the case, our results may be consistent with those of Serafeim (2015).

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9

The Influence of Corporate Governance on the Adoption of The Integrated Report: A first Study on IIRC Pilot Programme

Maria Federica Izzo and Giovanni Fiori

Abstract This chapter has three main aims. First, it discusses the concept of Integrated Report (IR) as a privileged instrument of companies' voluntary disclosure practices that answers to the investors and regulators' call for a greater focus on companies' strategy, governance, future performance and risks, overcoming a great part of the traditional financial statement's limitations. Second, it introduces key issues currently being debated relating to the IR Pilot Program and the main characteristics of the companies that decided to adhere to it. Finally, it shows some empirical first results about the corporate governance factors associated with the voluntary decision to prepare an Integrated Report according to the IR International Framework. In so doing the authors draw some conclusions about how Corporate Governance structure and mechanisms—such as legal environment, composition of the board of directors or ownership structure—are related to company's disclosure policies and the decision to adopt Integrated Report.

M. F. Izzo (✉) • G. Fiori
LUISS Guido Carli University, Rome, Italy

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Introduction

Corporate Governance and sustainability topics have gained prominence in recent years due to a number of different factors: the accounting scandals that have highlighted the limits of the international regulation about governance and disclosure, the economic crisis that has changed the way organizations run their business and a general lack of investor confidence in companies' disclosure system and in the effective relevance of traditional financial statements. In particular, the 2008 global financial crisis dramatically drove companies toward concepts such as business ethics, responsibility, transparency and accountability.

This has led to a significant increase in the number—and sometimes in the length—of documents or reports disclosed by companies as results of both mandatory requirement and voluntary decisions of the single organization—also thanks to the assumed advantages related to this kind of disclosure (Fiori et al. 2007; Berman et al. 1999; Schnietz and Epstein 2005; Di Donato and Izzo 2012; Izzo 2014). Unfortunately, the increase of information does not necessarily mean that the relevance of the communication process increases or that stakeholders are provided with the right information. Sometimes, the information disclosed can overlap; in the worst case it can be inconsistent and, definitely, a disclosure approach based on a number of different reports can create confusion, not providing stakeholders with the most powerful tool designed to correctly present the overall performance of the company.

One major critique refers to the real usefulness of the traditional financial reports and the lack of clarity about what is and is not material to the company business. For this reason, some have highlighted the limits of traditional financial statement as the main tool of corporate communication (Eccles and Krzus 2010), underlying the need for a report that brings together financial and non-financial information and provide both shareholder and stakeholders with relevant information regarding the company's environmental, social, governance and Corporate Social Responsibility (CSR) performance.

The IIRC justifies the need for a new reporting model with reference to how corporate reporting has developed in recent years. It argues:

As business has become more complex and gaps in traditional reporting have become prominent, new reporting requirements have been added through a patchwork of laws, regulations, standards, codes, guidance and stock exchange listing requirements. This has led to an increase in the information provided through:

Longer and more complex financial reports and management commentaries;
Increased reporting on governance and remuneration;
Standalone sustainability reporting.

Many currently perceive a reporting landscape of confusion, clutter and fragmentation. Much of the information now provided is disconnected and key disclosure gaps remain. (IIRC 2011, p. 4)

In other terms, there is an increasing sense among stakeholders that financial reporting does not properly capture the value created by companies, as markets require more information about intangible assets, constantly replacing the role of tangible assets in the total amount of invested capital (Lev 2001) and about environmental, social and governance aspects. Thus, IR encourages companies to communicate both tangible and intangible value, even where value is not currently captured by financial statements, but could affect financial performance.

The relevance of IR is justified by the need for a common language in company disclosure and by the severe limitations of the Annual Report and Sustainability Report as well (Fasan 2013). While financial information is based on common rules (IFRS, US or national GAAP), non-financial information has been produced according to many different guidelines, without international standards and with very few and uncertain auditing rules.

In light of the above, an increasing number of firms have begun to prepare a unique and integrated document, the Integrated Report, defined 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).

In 2011 the International Integrated Reporting Council (IIRC)—previously the International Integrated Reporting Committee—undertook a new project focused on developing an internationally accepted Integrated Reporting (IR) framework to create the foundations for a new reporting model to enable organizations to provide concise communications of how they create value over time. After a consultation process, the IIRC published the first version of its International Integrated Reporting Framework (IR Framework) in December 2013.

Taking into account these considerations, this chapter has three main aims. First, it discusses the concept of IR as a privileged instrument of companies’ voluntary disclosure practices. Second, the chapter introduces key issues currently being debated relating to the IR Pilot Program and the main characteristics of the companies that decided to adhere to it. Finally, it presents some first empirical findings about the corporate governance factors associated with the voluntary decision to prepare an Integrated Report according to the IR Framework.

Voluntary Disclosure and Integrated Report

The Financial Accounting Standards Board (FASB 2001) defines voluntary disclosure as “disclosures, primarily outside the financial statements, that are not explicitly required by generally accepted accounting principles or specific country rules”. The decision to disclose more than the required information is typically motivated by benefits as the reduction in information asymmetry (Lev 1992) and cost of capital (Leuz and Verrecchia 2000).

According to Healy and Palepu (2001), the determinants of voluntary disclosure can be divided into motivations and constraints, as summarized in Table 9.1. Motivations to voluntary disclosure are: capital market transactions; corporate control contest; stock compensation; increased analyst coverage; management talent signaling; limitations of mandatory disclosure. Constraints on voluntary disclosure include: disclosure precedent; proprietary costs; agency costs; political costs. Litigation costs,

Table 9.1 Voluntary disclosure. Motivations and constraints

Voluntary disclosure	
Motivations	Constraints
Capital market transactions	Disclosure precedent
Corporate control contest	Proprietary costs
Stock compensation	Agency costs
Increased analyst coverage	Political costs
Management talent signaling	
Limitations of mandatory disclosure	
Litigation costs	Litigation costs

finally, can be considered both as a motivation or constraint toward voluntary disclosure.

The increasing amount of attention toward corporate voluntary disclosure is mainly motivated by some limits of the mandatory one, that several worldwide scandals have been proved, with the consequence that investors' confidence in Annual Reports evidently decreased (Baker and Hayes 2004). Such limitations arise from the inability of traditional financial disclosure to adapt itself to the changes in the economic context, leading to a reduction in reliability and clarity. Too long and too complex documents, in fact, are not always able to disclose information—mainly, non-financial information—that investors need. Moreover, mandatory disclosure is strictly focused on financial data and past performance, reducing, in that way, the usefulness of the information provided.

In this scenario, IR (Busco et al. 2013a, b; Eccles and Krzus 2010; Frias-Aceituno et al. 2013; Mio and Fasan 2014) seems to perfectly overcome all the limitations of mandatory disclosure presented above. According to the IR Framework, the information provided through this new report is more consistent with investors' needs, there is a higher commitment to investors and other stakeholders that can benefit from more complete and reliable information, risk management is facilitated and threats to company's reputation are reduced. Besides, more accurate non-financial information is available to data suppliers. The latter implies that IR could play a strategic role in simplifying corporate disclosure and providing more relevant information to stakeholders and, particularly to capital providers. Table 9.2 summarizes which voluntary disclosure's motivations or constraints appear relevant for IR adoption.

Table 9.2 Voluntary disclosure and IR

Voluntary disclosure		
<i>Motivations</i>	<i>Beneficiary</i>	<i>Impacted by IR</i>
Capital market transactions	Investors	√
Corporate control contest	Company/investors	√
Stock compensation	Managers/company/investors	
Increased analyst coverage	Analysts/investors	√
Management talent signaling	Job market/investors	√
Limitations of mandatory disclosure	Investors	√
Litigation costs	Company/investors	
<i>Constraints</i>	<i>Beneficiary</i>	<i>Impacted by IR</i>
Disclosure precedent	Company/investors	√
Proprietary costs	Company	
Agency costs	Company/investors	√
Political costs	Company/investors	
Litigation costs	Company/investors	

As pointed out above, Integrated Report can serve investors reducing agency costs and facilitating capital market transactions. At the same time, as an instrument that informs about significant risks, it permits a link between past and current performance, and between current performance and the organization's outlook and in so doing, it can be used in the corporate control contest. Managers, thus, can increase information disclosure in order to retain corporate control, explain the reasons for poor results and reduce the possibility of a firm's undervaluation. Moreover, IR can be considered as a tool companies can leverage on in order to increase the analyst coverage. A survey by Radley Yeldar (a corporate communications consultancy) commissioned by GRI (2012) on a sample of investors and analysts reveals that 80 % of the interviewees believe that non-financial information is very relevant or at least relevant to their investment decision-making, showing a clear preference for more comprehensive sources of financial and non-financial information. Moreover, 84 % of respondents stated that it is either very important or important to make explicit links between different dimensions of performance (Bartolini et al. 2013). In addition to that it's easily understandable that increasing voluntary disclosure decreases the cost of information acquisition by analysts (Lang and Lundholm 1996).

Voluntary disclosure is often analyzed taking into consideration the Signaling Theory (Ross 1977; Skinner 1994), firstly developed in relation to the information asymmetry in the labor market (Spence 1973). Signaling Theory posits that, as a consequence of information asymmetry problems, companies can decide to signal certain—non-mandatory—information in order to provide investors with relevant information and show that they are different (and better) than other companies, with the purpose of attracting capitals and enhancing a favorable reputation. Talented managers, for example, could voluntarily disclose information about earnings forecasts to reveal their talent, create a good reputation and obtain a good feedback by the market. Following the considerations made above, IR is seen as a possible solution to overcome the mandatory disclosure limitations. This because it is flexible (not all capitals are equally relevant or applicable to all organizations), concise, long-term oriented, focused on both financial and non-financial information, addressed to providers of financial capital, although the Framework states that it will be a benefit to all stakeholders.

As any other company's activity, the decision to disclose more than the required information or to implement new processes—often expensive and demanding—represents a disclosure precedent for managers, as it means that they are expected to maintain the same pattern in the future. In other terms, the market would expect the company to keep disclosing that information in the time and this could provide a clear incentive for managers to reduce voluntary disclosure.

Another constraint to voluntary disclosure is represented by agency costs. Agency Theory posits that companies with high agency costs will try to reduce them using control mechanisms such as the monitoring activity and the voluntary disclosure (Jensen and Meckling 1976; Williamson 1981; Fama and Jensen 1983). In the Jensen and Meckling (1976) framework, the link between the organizations' disclosure policies and the internal mechanisms of corporate governance could work in two opposite ways, complementary or substitutive. If the nature of the link is substitutive, corporate governance and disclosure act as substitutes, and thus the company has no advantage in improving at the same time the two mechanisms of accountability: it will strategically choose to strength on just one of them (Rediker and Seth 1995). In other terms, since disclosure is not costless, companies might opt for developing internal governance mechanisms instead of disclosing more information.

The IR Pilot Program

The IIRC Pilot Program was established in 2011 in order to enable businesses and investors to share experiences and to create the conditions for widespread adoption of IR. The Program was addressed to a group of organizations, termed the IIRC Business Network, that voluntarily decided to test the principles and concepts of IR in their organizations.

This Program played a large part in testing the robustness of the IIRC Framework, which is designed as a practical response to address the key challenges of the evolution in corporate reporting. It aims to:

- encourage organizations to innovate in their reporting practices;
- inform the future evolution of reporting and investor practices;
- drive convergence in international reporting guidance.

The Program drew on a dedicated group of investors and other stakeholders, in order to understand the perspectives of information users on the content and format of Integrated Reports.

According to Paul Druckman, CEO of IIRC, the Pilot Program is “an innovation hub—made up of people who want to push the boundaries just a little bit further, to challenge, or at least question orthodox thinking, and to acknowledge the importance of reporting to the way our organizations think and behave” (IIRC 2013). The companies that decided to adhere to the Pilot Program (PP) include the Coca Cola Company, Danone, Eni, Deutsche Bank, HSBC Holding, Marks and Spencer, Microsoft Corporation, Tata Steel and Unilever.

In addition, in March 2012 the IIRC Investor Network was established in order to provide institutional investors’ input to ensure that the investor’s perspectives are appropriately reflected in the framework’s development process and that information businesses communicate in their Integrated Reports is value-relevant and supports capital market decision-making. The Investor Network includes Rockefeller Financial, Calvert, Ethos Foundation and DWS Investment GmbH (DB Advisors of Deutsche Bank Group).

Some figures relating to the main characteristics of the companies that joined the PP over time are presented in Table 9.3. The number of members of the Pilot Program were, in 2011, 78, while in September 2014,

Table 9.3 Pilot Program business and investor network

<i>Pilot Program business network</i>						
	Year 1		Year 2		Year 3	
Number of companies	78		99		104	
Listed	45	58 %	59	60 %	63	61 %
Non listed	34	44 %	40	40 %	41	39 %
European	50	64 %	56	57 %	55	53 %
Non-European	28	36 %	43	43 %	49	47 %
<i>Pilot Program investor network</i>						
	Year 1		Year 2		Year 3	
Number of investors	25		35		36	

Table 9.4 Pilot Program business participants by country

Businesses in the IIRC Pilot Program by country						
	Year 1		Year 2		Year 3	
Europe	50	64 %	56	57 %	55	53 %
Asia	8	10 %	11	11 %	12	12 %
North America	7	9 %	10	10 %	11	11 %
South America	5	6 %	11	11 %	13	13 %
Africa	4	5 %	6	6 %	7	7 %
Australasia	4	5 %	5	5 %	6	6 %
Total	78		99		104	

Table 9.5 Pilot Program business participants by industry sector

Businesses in the IIRC Pilot Program by industry classification						
	Year 1		Year 2		Year 3	
Financials	27	35 %	34	34 %	36	35 %
Consumer goods and services	12	15 %	13	13 %	15	14 %
Industrial	11	14 %	18	18 %	17	16 %
Utilities	8	10 %	8	8 %	8	8 %
Basic materials	7	9 %	8	8 %	9	9 %
Telecommunications and technology	6	8 %	6	6 %	7	7 %
Healthcare	5	6 %	3	3 %	4	4 %
Oil and gas	2	3 %	9	9 %	8	8 %
Total	78		99		104	

when the testing phase was officially closed; the Pilot Program business network was made up of 104 organizations.

The table gives the number of listed and non-listed companies over the 3 years of the Program. From the above findings it appears that listed

companies represent the majority of the participants (58 % in Year 1; 60 % in Year 2 and 61 % in Year 3), suggesting that listed companies are particularly interested in taking part into this process, as they recognize the market need for additional, more complete and concise information about performance and value. At the same time, the number of investors increased by 44 % over the 3 years. This is consistent with the idea that IR can lead to more effective capital allocation decisions and to better long-term investment returns for investors, the primary audience of IR.

The majority of these companies are European, with Netherlands and United Kingdom that represent, on average, the 13 % and 14 % of the entire panel adhering to the Program.

The first stock exchange that joins the IIRC Pilot Program was a European company: Germany's stock exchange operator, the Deutsche Börse Group joined in 2012.

Asia is the second continent, in terms of number of participants, and among the others, Japan is the country with the higher number of companies adhering to the Program.

Africa is completely represented by South African companies. South Africa was the first country to require listed companies to produce an Integrated Report. In particular, following on from the King III initiatives in March 2010, listed companies on the Johannesburg Stock Exchange were mandated (on a comply or explain basis) to provide an IR. In this sense, IIRC Pilot Program participants have been catalysts for a South African Integrated Reporting Network in collaboration with the Johannesburg Stock Exchange, the South African Institute of Chartered Accountants and the Integrated Reporting Committee of South Africa.

Of these companies, it appeared that the financial sector is the one with the higher number of representatives in the Pilot Program (about 35 % of the participants for the 3 years). The strong representation of accounting firms (as from 2011 a great number of professional accountancy bodies, the largest private accountancy firms and regulators decided to adhere to the PP) sent a clear message: the increasing relevance of this new communication instrument and the fact that they were more than interested in reforming financial reporting.

Among the "consumer goods and service" companies, major multi-intationals are present, such as Danone, Marks and Spencer, Unilever, Pepsi and The Coca Cola Group.

What is quite unexpected is that a sensitive sector as “oil and gas” is not so well represented as one could expect due to the impact of these activities on the environment and the special attention traditionally paid by these companies to their stakeholders. In 2011, just two companies from this sector decided to adhere to the PP. This could be interpreted in line with some criticisms (Rensburga and Botha 2014) to IR that underline that IIRC has abandoned the goal of reporting sustainability and IR “is not to cover in a comprehensive fashion the impact of the firm’s activities on stakeholders” (Flower 2015, p. 15). Having said that, referring to the adherence to the PP, the situation has been changed since then, and in 2013 this sector represents 8 % of the entire Program.

On the participation to the PP, it’s relevant to underline that deciding to adhere to the Program is costly, non-mandatory and particularly demanding in terms of resources (organizational and human), time and efforts required.

The Influence of Corporate Governance Structures on Disclosure

According to OECD Principles of Corporate Governance (2004), “a strong disclosure regime can help to attract capital and maintain confidence in the capital markets. By contrast, weak disclosure and non-transparent practices can contribute to unethical behavior and to a loss of market integrity at great cost, not just to the company and its shareholders but also to the economy in general”.

The relationship between corporate governance and the disclosure practice of companies have been widely analyzed in literature (Adams 2002; Eng and Mak 2003; Ricart et al. 2005; Healy and Palepu 2001), with a particular focus on the corporate governance structure and the Board of Directors characteristics (BoD). Jensen and Meckling (1976) underline the existence of a link between information disclosure and internal mechanisms of Corporate Governance, on the assumption that effective corporate governance mechanisms can reduce agency costs, information asymmetries and opportunistic behavior. The same results can be achieved by the BoD’s activity, through the dissemination of

information (Lev 1992; Richardson and Welker 2001). Based on the above-mentioned arguments, we assume that there is a strong relationship between BoD and the IR, meaning that some BoD characteristics can affect the disclosure policies adopted by a company and the decision to adopt (or not) the IR. In other terms, we are supposing the existence of a complementary relationship between the functioning of the Board of Directors (measured by its size, activity, diversity, independence) and the incentive for a firm to provide voluntary disclosure through the Integrated Report and, in particular, signaling its role of early adopters thanks to the participation to the IR Pilot Program.

Size of the Board

Concerning the size of the Board of Directors, many authors found out that in large companies boards are characterized by more severe agency problems, and therefore monitoring processes are less optimal (Yermack 1996; Eisenberg et al. 1998; Coles et al. 2008).

According to Larmou and Vafeas (2010), a larger board offers ‘more knowledge and expertise, as well as more capacity for monitoring and sharing the workload’. As the overall purpose of IR is to communicate and illustrate a broader understanding of the organizational performance compared to traditional reporting, it is clear that in order to fulfill the IR Framework requirements, different kind of expertise are required to the members of the board. This kind of expertise, in our idea, is more common in larger BoD.

Accordingly, we propose the following hypothesis:

H1: *Ceteris paribus*, adhesion to the IR Pilot Program is positively related to board size.

The Activity of the Board

Academic literature provides not unanimous evidence about the level of the BoD activity and the level of information disclosure. Some studies confirm that a BoD with more meetings during the year performs a

better supervisory function and there are fewer problems of asymmetric information (Kanagaretnam et al. 2007). Lipton and Lorsh (1992) state that an active BoD is a more effective because the frequency of its meetings allows members to better control the managers, and leads them to show greater interest in disclosing information and thus keep stakeholders informed of their efforts.

These considerations lead to the following hypothesis.

H2: *Ceteris paribus*, adherence to the IR Pilot Program is positively related to the activity of the board.

Gender Diversity

In relation to gender diversity, several authors have argued that the presence of women at senior management level positively affects company behavior, because these board members have the roles of wife and mother into their professional environment (Betz et al. 1989), applying ethical frameworks and criteria that differ from those used by men (Harris 1989). This is often associated with greater information transparency, especially regarding sustainability issues (Barako and Brown 2008; Prado-Lorenzo and Garcia-Sanchez 2010) and reputation (Bear et al. 2010).

Female directors are more participative (Eagly et al. 2003), democratic (Eagly and Johnson 1990), and communal than men (Rudman and Glick 2001), then increasing board gender diversity could help the board in better assessing the needs of diverse stakeholders. That's also because female directors are more likely than male to have expert backgrounds outside of business and to bring different perspectives to the board (Hillman et al. 2002), together with a higher level of charitable giving (Williams 2003), more favorable work environments (Johnson and Greening 1999), and higher levels of Environmental CSR (Post et al. 2011).

We therefore hypothesize the following:

H3: *Ceteris paribus*, adherence to the IR Pilot Program is positively related to the presence of women in the board.

The Role of Non-executive Within the Board

An independent board, often related to the presence of non-executive directors, is considered a crucial mechanism to control managers (Fama and Jensen 1983; Agrawal and Knoeber 1996), because independent directors can ensure a proper conduct by the company in accomplishing its mission (García-Sánchez et al. 2011). In this sense, non-executive directors are considered as a mechanism for monitoring and controlling the actions of the managers and protecting the shareholders interests as well (Weir and Laing 2003). The larger the proportion of non-executive directors on the board, the more effective the monitoring role on managerial opportunism. In so doing, the quality and quantity of voluntary disclosure will increase (Fama and Jensen 1983).

Therefore, the following hypothesis is proposed:

H4: *Ceteris paribus*, adhesion to the IR Pilot Program is positively related to the number of non-executive directors in the board.

The Presence of Blockholders

A possible threat to the effectiveness of the monitoring activity fostering by non-executive directors could be found in the presence of large controlling shareholders—also referred to as blockholders—that can influence the director's nomination process as well as the board and the committee's agenda. In addition, controlling insider shareholders are reluctant to disclose non-mandatory information that could limit their possibility to extract private benefits from their “insider” position (Leuz and Wysocki 2008). Fama and Jensen (1983) suggest that a diffused ownership structure represents an incentive for a firm to provide voluntary disclosure to shareholders. However, if the ownership is concentrated, there is less information asymmetry and no need for additional information. García-Meca and Sánchez-Ballesta (2010) demonstrate that firms with high levels of ownership concentration disclose less information to the market.

In line with prior arguments and results, we expect a higher demand for IR Pilot Program participation of firms with a high ownership disper-

sion compared to companies characterized by the presence of a blockholder. Thus, we pose the following hypothesis:

H5: *Ceteris paribus*, adhesion to the IR Pilot Program is negatively related to the presence of blockholders.

Methodology and Data

As already mentioned, in this part of the chapter we want to verify if the participation to the IR Pilot Program is influenced by some specific governance variables. We thus compare two samples totaling 178 European companies: on the one hand, a sample of 35 companies that joined the Pilot Program in 2011 (out of them, 26 were listed), on the other hand, a sample of 137 companies that did not adhere to it and that we randomly selected according to the proportion of countries and sectors of the companies joining the Program. The year 2011 was selected because the Pilot Program started at that moment.

The economic and financial data used were collected through Datastream database or using the available financial statements for the non-listed companies in 2011. The information about the governance structure and characteristics was obtained from the companies' corporate governance reports.

Our dependent variable (IR) measures if the companies in the sample prepare an Integrated Report, thus it takes the value 0 if the company only issues a financial statement and 1 if it prepares an Integrated Report adhering to the Pilot Program.

According to Frias-Aceituno et al. (2013), we selected the following governance variables that could be associated to the preparation of IR:

1. Board size (boardsize) corresponding to the number of directors serving on the board;
2. Gender diversity (women) corresponding to the number of women on the board of directors;
3. Activity of the board of directors (meeting) corresponding to the number of meetings held during the year;

4. Independence of the board (non-executives) corresponding to the number of non-executive directors serving on the board;
5. The presence of a blockholder (blockholders), corresponding to a shareholder or a group of shareholders holding at least 20 % of the shares, that, according to La Porta et al. (1999) is the threshold required in order to exert control.

Corporate size, measured by the logarithm of total assets (ITA) and profitability, measured by return on assets (ROA) at 31 December 2011, have been used as control variables in the analysis. To determine the effect of the covariates on the probability of participating to the IR Pilot Program a probit model has been fit to the data:

$$\Pr(Y = 1 | X) = \Phi(X'\beta)$$

where \Pr denotes probability, and Φ is the Cumulative Distribution Function (CDF) of the standard [normal distribution](#). The parameters β are typically estimated by [maximum likelihood](#).

We run a probit regression for each single governance variable controlling for profitability and corporate size, in order to test if any of them could positively influence the probability to participate to the Pilot Program.

$$\Phi^{-1}(p_i) = \beta_0 + \beta_1 x_i + \beta_2 ITA_i + \beta_3 ROA_i + \epsilon_i$$

where p_i represents the probability for firm i to participate to the PP and where x_i is the covariate whose effect on the probability of participating to IR Pilot Program is being tested.

Discussion of Results

Table 9.6 illustrates some descriptive statistics relating both to the total sample and to the separate samples of adhering and non-adhering companies.

Table 9.6 Descriptive statistics

Descriptive results				
	Mean	Std. dev.	Min	Max
<i>ROA</i>				
Total sample	5.035464	7.083158	-18.86	32.93
Pilot Program 1	4.687781	6.407396	-1.59	28.42
Pilot Program 0	5.120562	7.257421	-18.86	32.93
<i>Total assets</i>				
Total sample	8.85e + 07	2.65e + 08	1622.071	1.64e + 09
Pilot Program 1	1.01e + 08	2.87e + 08	1622.071	1.64e + 09
Pilot Program 0	8.53e + 07	2.60e + 08	31,665	1.56e + 09
<i>Board size</i>				
Total sample	9.11236	5.037572	1	25
Pilot Program 1	9.714286	4.566962	2	18
Pilot Program 0	8.965035	5.150431	1	25
<i>% of NED</i>				
Total sample	.516176	.3983029	0	1
Pilot Program 1	.4970414	.398525	0	1
Pilot Program 0				
<i>Women</i>				
Total sample	1.016854	1.157021	0	4
Pilot Program 1	1.142857	1.166767	0	4
Pilot Program 0	.986014	1.156647	0	4
<i>Meeting</i>				
Total sample	8.94382	3.968405	2	31
Pilot Program 1	9.114286	3.802255	2	18
Pilot Program 0	8.902098	4.019871	3	31

In more details, the companies joining the Pilot Program (Pilot Program 1) are smaller and have lower profitability than those not joining the Program (Pilot Program 0). In terms of board size, the companies joining the Program are a bit larger; they are characterized by a higher presence of women and their boards meet more frequently during the year. Nevertheless, no significant differences have been found between the firms joining the Program and the others.

On the contrary, the two samples are quite similar concerning the presence of Non-executive-directors (NED) and the presence of a blockholder.

As we outlined earlier, we tested five hypotheses. Table 9.7 presents the results of the probit regression.

Table 9.7 Probit regression. Results

	Coef.	Robust std. err.	z	P>z	(95 % conf. interval)
<i>Board size</i>					
boardsize_large (> 12)	.0608532	.274681	0.22	0.825	-.4775116
boardsize_small (< 4)	-.766397*	.3851604	-1.99	0.047	-1.521298
ITA	.0046686	.0501524	0.09	0.926	-.0936284
ROA	-.0068682	.015436	-0.44	0.656	-.0371223
_cons	-.8091751	.8074532	-1.00	0.316	-2.391754
<i>Presence of women</i>					
women	4.073551**	1.528582	2.66	0.008	1.077585
ITA	.1984622*	.0801615	2.48	0.013	.0413485
Women_ITA	-.2503221**	.0964702	-2.59	0.009	-.4394002
ROA	-.0061724	.0161226	-0.38	0.702	-.037772
_cons	-4.004388	1.278776	-3.13	0.002	-6.510743
<i>Number of meetings</i>					
meeting	.2805049	.2849815	0.98	0.325	-.2780486
ITA	.0225641	.0462118	0.49	0.625	-.0680094
ROA	-.0011647	.0153708	-0.08	0.940	-.031291
_cons	-1.259077	.7359202	-1.71	0.087	-2.701454
<i>NED and blockholder's presence</i>					
NED	.0019929	.0318017	0.06	0.950	-.0603372
ITA	.031612	.0556623	0.57	0.570	-.077484
ROA	-.0043686	.0157063	-0.28	0.781	-.0351524
blockholders	-.0069106	.3267937	-0.02	0.983	-.6474144
block_NED	-.0197514	.0379695	-0.52	0.603	-.0941702
_cons	-1.276876	.8820188	-1.45	0.148	-3.005601

*p < .05, **p < .01, ***p < .001

Our findings show, consistently with García-Sánchez et al. (2011) and Frias-Aceituno et al. (2013), that companies with smaller boards have lower probability to join the IR Pilot Program compared to the companies with medium board size, and the relation is statistically significant (p value 0.047), while companies with larger board have a greater probability to join the Program when compared to the medium board size companies, although such relation is not statistically significant.

Concerning the presence of women, our results show that if women serve on a board there is a positive and statistically significant effect on the probability to join the Pilot Program, independently of the number of women. This is consistent with the findings of Barako and Brown (2008) and Prado-Lorenzo and Garcia-Sanchez (2010). In particular the interaction between women and corporate size is statistically significant (p value 0.009) showing that the effect of the presence of women on the probability of joining the Pilot Program decreases as the size of the company increases. The presence of women on the board has a greater effect on the probability of joining IR for small firms as if to intend that small firms that have women on the board are much more willing to participate to the Pilot Program. Small firms that allow for gender diversity in the board, for example, are more open minded, while—probably—the presence of women on large companies' boards is almost a standard and does not necessarily implies open mindedness.

Concerning the activity of the board, the relation between the number of meetings and the decision to participate to the Pilot Program is positive but not statistically significant.

Considering the role of Non-executive-directors, blockholder and the interaction between the two variables, consistently with our hypotheses, the presence of Non-executive-directors is associated with a higher probability to join the Program while the presence of blockholders holding at least 20 % of the shares reduces this probability, but for both variables the relation is not statistically significant. Eventually the interaction between blockholders and Non-executive-directors is not statistically significant but affects negatively the probability to join the IR Pilot Program.

Summary and Conclusions

The aim of this chapter was to illustrate the increasing relevance of Integrate Reporting and to address the question of the relation between some corporate governance characteristics and the decision to join the IR Pilot Program.

Commencing from an analysis of the literature on the subject of voluntary disclosure and its determinants, we highlighted the real potential of IR that, in our opinion, is the capability to overcome the limitations of traditional disclosure instruments.

In the second part of the chapter, we analyzed the relationship between some corporate governance characteristics and the decision to adhere to the IR Pilot Program, that groups those companies willing to implement—on a voluntary basis—their Integrated Report as described by the IIRC. Our findings show a significant relation between the decision to adhere to the PP and both gender diversity and board size. We showed that if women serve on a board there is a positive and statistically significant effect on the probability to join the Pilot Program, independently of the number of women, and that this effect is greater for smaller firms. We also showed that companies with medium board size have greater probability to join the Program than those with smaller board size.

The main limitation of this study is the difficulty in generalizing the empirical findings gathered. This happens for different reasons. First, there is a possible bias in the sample selection because while the companies in the Pilot Program are both listed and non-listed ones; the sample of comparable firms is entirely represented by listed companies. Second, the study should be extended to non-European companies and the hypothesis tested for companies that decided to join the Program after 2011. In addition, it would be interesting to include some other variables capturing different aspects other than corporate governance, as the decision to join the Program, as the results of our analysis have showed, could also be influenced by other factors such as strategy decisions and communication policies.

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10

Institutional Determinants of IR Disclosure Quality

Marco Fasan, Carlo Marcon, and Chiara Mio

Abstract The aim of this chapter is to study whether and how the institutional context where a company operates influences Integrated Reporting (IR) disclosure quality, as measured through a unique hand-collected dataset. Our results show strong empirical support for the hypothesis that a country's institutional characteristics significantly shape IR disclosure quality. In particular, we find that disclosure quality is higher in civil law countries and in countries with higher employee protection, levels of market coordination, ownership concentration, education, density of trade unions, corporate social responsibility and economic development. Conversely, the higher the investor protection, the lower the IR disclosure quality. These results allow us to draw new insights on the nature of IR and its relationship with institutional contexts.

M. Fasan (✉) • C. Marcon • C. Mio
Department of Management, Ca' Foscari University of Venice, Venice, Italy

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Introduction

Companies implementing Integrated Reporting (IR) belong to very different institutional contexts. While the International Integrated Reporting Council (IIRC) is based in London and most of the IIRC Pilot Program companies are in Europe, North America and South Africa, there is an increasing number of organizations from all over the world taking their own path toward IR. In particular, companies belonging to the IIRC Business network are from Brazil, China, Japan, South Korea, Turkey, and Russia (among other countries).

The aim of this chapter is to study whether and how the institutional context where a company operates influences IR disclosure quality. This research question is particularly relevant because the IIRC Framework is principle-based and allows very different interpretations and levels of compliance based on the individual companies' choices.

In order to answer this research question, we rely on a unique hand-collected dataset on IR disclosure quality. More specifically, we analyze 2009 and 2013 IRs published by IIRC Pilot Program companies. Each report is evaluated using 72 binary format questions, where the answer "yes" receives 1 point and the answer "no" gets a score of 0. 37 Questions relate to the six capitals and 35 questions relate to the content elements. Therefore our dependent variable consists of a compliance score of IR disclosure ranging from 0 to 72. We follow Jensen and Berg (2012) in the identification of institutional variables and divide them into the following categories: legal, financial, educational and labor, cultural and economic.

Our results reveal strong empirical support for the hypothesis that a country's institutional characteristics significantly shape IR disclosure quality. In particular, we find that disclosure quality is higher in civil law countries and in countries with higher employee protection, levels of market coordination, ownership concentration, companies' involvement in education, density of trade unions, corporate social responsibility and economic development. Conversely, investor protection has a negative impact on IR disclosure quality.

Overall, our results allow us to draw some interesting insights about the nature of IR. In particular, they are consistent with the idea of IR

disclosure quality being higher in contexts where the relevance of stakeholders is higher (thus, in civil law countries and in contexts with higher employment but lower investor protection). Given the notion of IR being primarily an investor-oriented tool, this evidence requires some consideration by standard setters, such as the IIRC. On the one hand, it may be that IR is still perceived as an instrument of sustainability disclosure, despite being an evolution of financial reporting rather than sustainability reporting (SR). On the other hand, it may be that, for the moment, companies that are more used to managing stakeholder relationships are doing a better job in following some of the IR principles.

Another interesting result is that companies belonging to more developed contexts, in terms of economic development, have higher IR disclosure quality. This finding is in line with the idea of IR being more relevant in contexts where critical success factors are linked with intangible assets (i.e. more developed economies). Reputation, trust, innovation and all the other intangible assets that allow companies to produce and sustain value over time will be even more important in more developed economies. Therefore, companies belonging to these contexts have higher incentives to provide a better representation of these capitals (and thus a higher IR disclosure quality).

This chapter contributes to previous literature on the determinants of IR (Frias-Aceituno et al. 2013a, b, 2014; Sierra-Garcia et al. 2013; Garcia-Sanchez et al. 2013; Jensen and Berg 2012) by introducing a new and more refined variable (IR disclosure quality) that allows us to draw new insights on the nature of IR and its relationship with institutional contexts.

Literature Review on the Determinants of IR

Many studies have analyzed the determinants of SR, but only a few have investigated the determinants of IR.

Following Hahn and Kuhnen (2013), the determinants of SR can be grouped into internal and external ones. The internal determinants include company size, financial performance, social and environmental performance, and ownership structure, while the external determinants

mainly cover issues related to corporate visibility, sector affiliation and country of origin.

Among internal determinants, the only one that is consistently found to have a positive impact on SR is company size. This variable, which is usually measured by total assets, revenues, number of employees or market capitalization, can be considered to have a positive effect on the adoption, extent and quality of SR, assuming that larger companies are more visible and thus face greater stakeholder pressure (Fortanier et al. 2011; Gallo and Jones Christensen 2011). Moreover, larger companies tend to have lower marginal costs of disclosure (Haddock 2005).

As regards financial performance, the empirical results are rather mixed. When financial performance is meant as profitability (measured by return on assets, return on equity or market returns), positive correlation seems to be likely at least in terms of influence on the extent of SR, because profitability can be assumed to increase the ability to cope with the consequences of disclosing potentially damaging information (Cormier and Magnan 2003; Haniffa and Cooke 2005; Sotorrio and Sanchez 2010). While financial performance is investigated in terms of indebtedness, empirical research provides more ambiguous findings. According to Haniffa and Cooke (2005), SR may be used to legitimate corporate activities toward creditors, and therefore companies with high leverage could have more incentive to engage in SR.

Similarly, empirical evidence regarding the influence of social and environmental performance on SR is also contradictory. On the one hand, companies may want to signal good performance, implying a positive effect on reporting. On the other hand, companies with weaker performance may be more actively engaged in SR in order to mitigate legitimacy threats.

Looking at the impact of ownership structure on SR, the most consistent results are related to a company's listing on the stock market and concentrated/dispersed ownership. In fact, many studies find that publicly listed companies disclose a higher level of sustainability-related information (Da Silva Monteiro and Aibar-Guzman 2010; Gamerschalg et al. 2011) in order to comply with specific regulations and/or cope with stakeholder pressure. Furthermore, companies with concentrated ownership are less likely to adopt SR, given that dominant shareholders are sup-

posed to already have access to that relevant information, while dispersed ownership increases the need to reduce information asymmetry by using SR (Brammer and Pavelin 2006).

Among external determinants, a positive influence of corporate visibility (mainly measured by media exposure) is acknowledged by several empirical studies (Kent and Monem 2008; Nikolaeva and Bicho 2011). In other words, firms tend to adopt SR or increase their disclosure in order to mitigate the reputational risks of bad press and exploit the possible benefits of good press.

Another external determinant with rather consistent evidence of having a significant influence on SR is a company's sector affiliation (see, among others, Clarkson et al. 2008; Parsa and Kouhy 2008). Companies from industries with high social and environmental impacts may need to engage in SR in order to respond to industry-specific stakeholder pressure. Moreover, sustainability disclosure may be driven by mimetic tendencies developed within the same sector.

Finally, SR may also vary across countries and regions due to different legal, social and cultural factors. Some studies have pointed out differences between countries and regions regarding the adoption (Buhr and Freedman 2001), extent (Chen and Bouvain 2009; Prado-Lorenzo et al. 2009; Fortanier et al. 2011) and quality (Vormedal and Ruud 2009) of SR.

While determinants and motivations for SR have been widely examined, little is known about which factors affect the adoption, extent and quality of IR.

Some empirical studies have analyzed whether the decision to present an integrated report depends on firm-specific variables such as company size, profitability, growth opportunities and business sector. Most studies find a positive correlation between company size and IR adoption (Frias-Aceituno et al. 2013a, 2014; Sierra-García et al. 2013), because larger companies have higher visibility and are thus subject to greater pressure for transparency. According to the main theories of disclosure (agency, signaling and political cost theory), there should be a positive correlation between profitability and IR, although the findings to date have been inconclusive (Frias-Aceituno et al. 2013a, 2014). Regarding opportunities for business growth, it is to be expected that companies with higher

market-to-book values will disclose IR in order to reduce problems of information asymmetry. However, earlier studies show contradictory results (Frias-Aceituno et al. 2013a, 2014). Finally, the sector of business activity is another variable that is frequently used to account for the information provided by companies, since it is assumed that firms operating in the same sector will adopt similar patterns of behavior regarding the information they publish. However, Sierra-Garcia et al. (2013) provide limited evidence for the existence of an industry effect on IR, and Frias-Aceituno et al. (2014) show that business sector does not impact the choice of adopting IR.

Looking at less common determinants, Frias-Aceituno et al. (2014), using a sample of 1590 international companies for the period 2008–2010, find a negative impact of industry concentration on the development of IR. This evidence provides support for the hypotheses underlying the theory of proprietary costs as an explanatory factor for the business practice of IR. In other words, firms in monopolistic situations are less likely to publish integrated reports in order to preserve the abnormal profits being obtained. Based on 7144 worldwide observations, Sierra-Garcia et al. (2013) point out that the likelihood of preparing an integrated report is positively associated with having an assured corporate social responsibility report. Frias-Aceituno et al. (2013a) investigate the influence played by some features of the board of directors on presenting IR by examining 568 non-financial companies from 15 countries. They conclude that the size of the board of directors and its gender diversity are the main factors in the decision to disclose IR. Finally, Lai et al. (2014) investigate IR adoption from the strategic perspective of legitimacy theory, using a matching sample of 52 IR adopters (IIRC Pilot Program members) and 52 IR non-adopters. They show that IR adopters have significantly higher ESG disclosure ratings than non-adopters, thus rejecting the hypothesis (typical of legitimacy theory) of firms adopting IR as a response to a poor rating. Additionally, they find that other proxies of legitimacy pressures (size, leverage, profitability, industry) do not play a role in explaining IR adoption.

Other empirical studies have analyzed the influence of some country-level determinants on the adoption of IR. Based on institutional theory, Jensen and Berg (2012) show, in a sample of 309 firms, that IR com-

panies are different from traditional SR companies with regard to several institutional factors. Notably, they point out that IR companies are located in countries with different financial, educational, labor, cultural and economic systems, while political factors seem to have no significant effect. Frias-Aceituno et al. (2013b) examine the impact of one of the most important institutional factors, that is, the legal system, on the decision to present an integrated report. They find, in a sample of 750 international companies, that those located in civil law countries and where indices of law and order are high are more likely to publish an IR that fosters decision-making by different stakeholders. Finally, Garcia-Sanchez et al. (2013) focus on the role played by the national cultural system on the production of IR. Their empirical results show that companies located in societies with stronger collectivist and feminist values are more likely to prepare IR. Based on stakeholder theory, these scholars conclude that firms operating in countries most oriented toward the common good are more prone to develop IR.

Our research belongs to this last strand of studies because we believe that firm-level decisions are not sufficient to explain why firms from different countries disclose different levels of integrated information (Dong and Stettler 2011). However, our contribution is different from previous studies in that we aim to assess the influence of some institutional factors on the quality of IR disclosure rather than simply on the adoption of IR. Notably, we assess the quality of IR in terms of compliance with the IIRC Framework, using a sample of companies engaging in the IIRC's Pilot Program Business Network.

Hypothesis Development

As mentioned above, this chapter aims at assessing whether institutional factors may be considered as good explanatory variables for the quality of IR disclosure. Differences between countries in the adoption and diffusion of corporate reporting strategies are often analyzed with a background of institutional theory (see, among others, Matten and Moon 2008; Jackson and Apostolakou 2010; Brammer et al. 2012). According to this theory, organizations operate in contexts with politi-

cal, financial, educational, cultural and economic institutions that exert pressure on and have expectations of them. Accordingly, firms operating in countries with institutional similarities tend to adopt homogeneous patterns of behavior. In this regard, Matten and Moon (2008) developed a conceptual framework to explain different forms of CSR in different institutional contexts. They compared several historically grown national institutional factors in various countries in order to examine the pressure exerted on CSR by these factors.

It is worth noting that, beyond the impact of national institutional factors, business practices become institutionalized because they are considered legitimate. Legitimacy is reached through mimetic, normative and coercive isomorphism (DiMaggio and Powell 1983). Mimetic isomorphism implies that managers copy strategies of successful companies, which are regarded as best practices. Normative isomorphism means doing what is professionally correct, while coercive isomorphism means complying with rules imposed by external forces. However, considering that IR is a relatively new phenomenon, the impact of these kinds of isomorphism should be negligible.

Starting from these premises and following Jensen and Berg (2012), we shall formulate several hypotheses about the impact of institutional factors on the quality of IR.

Legal System

Following the ground-breaking study by La Porta et al. (1997), we analyze the legal system by comparing the common law and civil law systems applied in different countries. In common law countries, a company is considered to be an instrument for the creation of shareholder value. It can be assumed that the reports of companies from these countries try to meet shareholders' informational needs, which mainly require financial information rather than other types as in IR. Conversely, the civil law legal system is more stakeholder-oriented than common law. Such countries are characterized by having laws aimed at protecting the rights of workers and other stakeholders. Companies are viewed as a responsibility-bearing part of society. Accordingly, it is to be expected

that the reports of companies from civil law countries, which are aimed to satisfy the informational needs of a wider group of stakeholders and not only those of shareholders, go beyond financial information by producing an integrated report. Based on these considerations, we propose the following hypothesis:

H1.1. Companies from civil law countries are more likely to produce a higher degree of IR quality.

In order to analyze the impact of legal systems on IR in more detail, we distinguish between the level of investor protection and the level of employment protection.

In countries with high investor protection, it is important to meet shareholder needs, which are at the focus of traditional annual reports, while in countries with strong employment protection, social needs are highly valued, and it can be assumed that IR is more appreciated. Therefore, we propose the following hypotheses:

H1.2. Companies from countries with strong investor protection are less likely to produce a higher degree of IR quality.

H1.3. Companies from countries with strong employment protection are more likely to produce a higher degree of IR quality.

Financial System

According to the degree of market coordination, financial systems can be distinguished into market-based economies and bank-based economies. In the latter, banks have direct access to a company's data because of the close relationship between firms and banks. Therefore, financial intermediaries do not need extensive corporate reporting (including IR) for their monitoring and screening activities. On the contrary, in market-based economies, investors and bondholders base their decisions mainly on external and innovative forms of reporting. Based on these considerations, we propose the following hypothesis:

H2.1. Companies from countries with a higher degree of market orientation are more likely to produce a higher degree of IR quality.

Moreover, we think that ownership structure can affect the quality of IR disclosure. In fact, dominant owners usually get the desired information directly from the company and are therefore not dependent on published information. Controlling owners are not interested in publishing extensive, reliable and clear reports. We therefore hypothesize that:

H2.2. Companies from countries with a lower degree of ownership concentration are more likely to produce a higher degree of IR quality.

Educational and Labor System

The level of companies' involvement in post-secondary education is another important institutional condition. Besides philanthropic motives, investment in education allows companies to customize contents of education according to their needs. We argue that companies from countries with high involvement in education show a strong interest in research findings and new management practices (including IR). Accordingly, we propose the following hypothesis:

H3.1. Companies from countries with a higher involvement in post-secondary education are more likely to produce a higher degree of IR quality.

Labor systems differ sensibly among countries, primarily in terms of degrees of employee involvement in corporate decisions. This kind of involvement is often associated with the density of trade unions. Considering that corporate reporting usually reflects the value system of a company, and IR aims at providing useful information to a broad group of stakeholders (including employees), we formulate the following hypothesis:

H3.2. Companies from countries with a higher density of trade unions are more likely to produce a higher degree of IR quality.

Cultural System

One important aspect of a country's culture is the role played by companies in the perception of society. While in some countries corporate

responsibility is primarily limited to financial issues, in other countries corporate responsibility involves a broader set of environmental and social values. It can be assumed that the degree of national corporate responsibility affects firms' attitudes to disclosing information about their social and environmental activities in an integrated way with financial information. Thus, we derive the following hypothesis:

H4. Companies from countries with a higher national corporate responsibility are more likely to produce a higher degree of IR quality.

Economic System

Previous studies have shown that economic system is a relevant determinant of voluntary disclosure and SR (Neumayer and Perkins 2004; Islam and Deegan 2008). Companies from developed countries generally apply new management tools sooner than those in developing countries. Accordingly, we argue that it could be the case for IR as well, being considered at the cutting-edge of corporate reporting. Therefore we derive the following hypothesis:

H5. Companies from countries with higher economic development are more likely to produce a higher degree of IR quality.

Sample and Methodology

Our sample is composed by companies that participated in the IIRC's Pilot Program Business Network, which came to an end in September 2014 after 3 years of testing the principles behind IR. We analyzed the Integrated Reports for the years 2009 and 2013. In September 2014, the number of Pilot Program organizations was 104. From this list, we omitted non-profit organizations and companies for which integrated reports were not available for both 2009 and 2013. After this selection process, our sample was made up of 76 companies from 23 different countries, as shown in Table 10.1, for a total of 152 reports analyzed.

Each report was evaluated with a predefined set of criteria based on the requirements of the IIRC Framework. In order to provide some objective

Table 10.1 Sample composition by country

Company	Country	Company	Country
National Australia Bank Limited	Australia	Deloitte Netherlands	Netherlands
Slater & Gordon Lawyers	Australia	FMO	Netherlands
Stockland	Australia	N.V. Luchthaven Schiphol	Netherlands
Solvay	Belgium	Randstad Holding NV	Netherlands
CCR S.A	Brazil	ARM Holdings	UK
BRF S.A	Brazil	HSBC Holdings plc	UK
CPFL Energia	Brazil	Marks and Spencer Group plc	UK
Fibra Celulose S.A	Brazil	Sainsbury's	UK
Itau Unibanco	Brazil	The Crown Estate	UK
Natura	Brazil	Unilever	UK
Petrobras S.A.	Brazil	NIAEP	Russia
Port Metro Vancouver	Canada	Rosneft	Russia
Teck Resources	Canada	State Atomic Energy Corporation ROSATOM	Russia
Vancity	Canada	Uralsib	Russia
CLP holdings limited	China	DBS bank	Singapore
SK telecom	South Korea	BBVA	Spain
Novo Nordisk	Denmark	Enagas SA	Spain
Danone	France	Indra	Spain
Vivendi	France	Inditex	Spain
Deutsche Bank	Germany	Melià Hotels International	Spain
BASF SE	Germany	Repsol S.A.	Spain
EnBW Energie Baden-Württemberg AG	Germany	Telefónica S.A.	Spain
Flughafen Munchen GmbH	Germany	Diesel & Motor Engineering PLC	Sri Lanka
Deutsche Borse Group	Germany	Eskom Holding SOC Limited	South Africa
SAP	Germany	AngloGold Ashanti Limited	South Africa
Showa Denki Co. Ltd	Japan	Coega	South Africa
Takeda Pharmaceutical Company Limited	Japan	Gold Fields	South Africa
Kirloskar Brothers Limited	India	Sasol	South Africa

(continued)

Table 10.1 (continued)

Company	Country	Company	Country
Tata Steel	India	STRATE	South Africa
Generali Group	Italy	Volvo Group	Sweden
Enel	Italy	Turkiye Garanti Bankasi Anonim Sirketi	Turkey
Eni	Italy	Cliffs Natural Resources	US
Snam	Italy	Jones Lang LaSalle Incorporated	US
Terna S.p.A.	Italy	Microsoft Corporation	US
New Zealand Post	New Zealand	PepsiCo Inc	US
AEGON NV	Netherlands	Prudential Financial Inc.	US
AkzoNobel N.V.	Netherlands	The Clorox Company	US
BAM Group	Netherlands	The Coca-Cola HBC	US

Source: Our dataset from a sample of IIRC Pilot Program companies

basis for our assessment, the set of criteria consists of some binary format questions, where the answer “yes” receives 1 point and the answer “no” gets a score of 0. In determining the questions, we considered if they were compliant with the IIRC Framework as much as possible, verifiable by an external user, relevant in capturing the value creation process, and in the “spirit” of IR.

A total of 72 questions were included in the overall evaluation for analysis purposes: 37 questions related to the six capitals (shown in Table 10.2 as Tot partial 1) and 35 questions related to the content elements (shown in Table 10.2 as Tot partial 2). Therefore, our dependent variable consists of a compliance score of IR disclosure which can potentially range from 0 to 72 and which is specified in Table 10.2 as Total.

The independent variables come from several sources. Some of these are not completely updated; however, institutional factors are generally characterized by a high degree of temporal stability.

To test hypothesis H.1.1. a dummy variable (COCI) is defined, which takes the value 1 for companies from common law countries and 0 for companies from civil law countries, following the classification proposed by La Porta et al. (1998).

Table 10.2 Determinants of IR disclosure quality

<i>COCI—common/civil law</i>					
	Common	Civil	Difference	<i>t</i> test	Wilcoxon test
Tot partial 1	22.48	23.6	-1.11	-1.01	-1.10
Tot partial 2	14.98	17.58	-2.60	-2.68***	-2.64***
Total	37.46	41.18	-3.72	-2.15**	-2.16**
<i>INPR—investor protection</i>					
	High	Low	Difference	<i>t</i> test	Wilcoxon test
Tot partial 1	23.91	23.03	-0.87	-0.82	-0.68
Tot partial 2	15.77	17.47	1.69	1.85**	1.82*
Total	39.69	40.41	0.81	0.49	0.49
<i>EMPR—employee protection</i>					
	High	Low	Difference	<i>t</i> test	Wilcoxon test
Tot partial 1	23.53	23.33	-0.19	-0.18	-0.35
Tot partial 2	17.67	15.20	-2.46	-2.69***	-2.63***
Total	41.21	38.54	-2.66	-1.59*	-1.65*
<i>COOR—level of market coordination</i>					
	High	Low	Difference	<i>t</i> test	Wilcoxon test
Tot partial 1	23.65	22.63	0.69	0.56	-0.60
Tot partial 2	17.61	14.02	-3.59	-3.56***	-3.45***
Total	41.25	36.97	-4.27	-2.32***	-2.28**
<i>OWNE—ownership concentration</i>					
	Dispersed	Concentrated	Difference	<i>t</i> test	Wilcoxon test
Tot partial 1	22.31	24.18	1.87	1.71**	1.36
Tot partial 2	15.90	17.28	1.37	1.40*	1.19
Total	38.22	41.46	3.24	1.88**	1.68*
<i>EDUC—education</i>					
	High	Low	Difference	<i>t</i> test	Wilcoxon test
Tot partial 1	23.81	22.72	-1.09	-0.97	-1.19
Tot partial 2	17.21	15.56	-1.65	-1.70*	-1.78*
Total	41.02	38.28	-2.74	-1.57 *	-1.73 *
<i>TRAD—density of trade unions</i>					
	High	Low	Difference	<i>t</i> test	Wilcoxon test

(continued)

Table 10.2 (continued)

Tot partial 1	23.76	22.86	-0.89	-0.80	0.40
Tot partial 2	17.21	15.63	-1.57	-1.63*	-1.57
Total	40.97	38.5	-2.47	-1.42 *	-1.48
<i>NACO—national corporate responsibility</i>					
	High	Low	Difference	t test	Wilcoxon test
Tot partial 1	23.26	23.69	0.42	0.40	0.25
Tot partial 2	17.63	15.40	-2.23	-2.44***	-2.30**
Total	40.90	39.10	-1.80	-1.08	-1.12
<i>GNI—gross national income</i>					
	High	Low	Difference	t test	Wilcoxon test
Tot partial 1	23.85	23.01	-0.83	-0.78	-0.77
Tot partial 2	17.28	15.98	-1.30	-1.41*	-1.34
Total	41.13	39	-2.13	-1.29 *	-1.23
<i>EFI—economic freedom index</i>					
	High	Low	Difference	t test	Wilcoxon test
Tot partial 1	29.5	23.02	-6.47	-3.11***	-2.97***
Tot partial 2	16.80	16.66	-0.13	-0.07	-0.8
Total	46.3	39.69	-6.60	-2.01**	-1.97**

This table shows the results of the univariate analysis. It compares means and medians of the IR disclosure quality variables (Tot partial 1; Tot partial 2; Total) conditional on the different determinants, through a *t* test and Wilcoxon test. Coefficients' significance: * $p < 0.10$; ** $p < 0.05$; *** $p < 0.01$

Source: Our dataset from a sample of IIRC Pilot Program companies

The level of investor protection within a country is described by INPR, which is computed by the International Finance Corporation and The World Bank (2011). This variable is set between 0 and 10, with higher values indicating more investor protection. The level of employment protection within a country, instead, is depicted by EMPR, which is computed by the Organisation for Economic Co-operation and Development (OECD) (2010). It is listed between 0 and 6, with higher scores indicating stronger employment protection.

COOR describes the level of market coordination within a country and is standardized between 0 and 1, with higher scores showing a higher level of market coordination. Instead, we use OWNE as a proxy for the degree of ownership concentration. This variable takes the value 1 if the

state is likely to have capital holdings in the ten largest firms, and the value 0 if the state is not one of the three largest shareholders (La Porta et al. 1998).

Companies' involvement in post-secondary education (EDUC) in a country is measured by the share of private expenditures to public expenditures for tertiary education as a percentage of gross domestic product, with data taken from UNESCO (2010). As a proxy for labor systems, we use the density of trade unions within a country (TRAD), which is equal to the ratio of salary-earning trade union members to the total number of salary-earners as reported by the OECD (2010).

As regards the cultural system, we take account of national corporate responsibility (NACO) according to the classification of AccountAbility (2005). NACO ranges from 0 to 100, with 100 indicating the highest level.

Finally, the level of economic development is measured by two indicators: per capita Gross National Income (GNI) and the Economic Freedom Index (EFI). For the first variable, data come from The World Bank (2010), while data for the second proxy are published by the Heritage Foundation (2010). EFI measures the level of state intervention in economic activities and ranges from 0 to 100, with 100 showing the highest degree of economic freedom.

In order to test our hypotheses, we performed parametric (t test) and non-parametric (Wilcoxon test) univariate analyses, which compare means and medians of our dependent variable (IR compliance score) conditional on the independent variables. If the test is significant, this means that the mean (median) of one group (for instance, common law countries) is significantly different compared to the mean (median) of the other group (for instance, civil law countries).

Results and Discussion

Table 10.2 displays the results regarding our hypotheses. In particular, it shows the IR disclosure quality mean for each of the sub-groups created for each independent variable and the results of the t test and Wilcoxon test.

Legal System

Our results support Hypothesis 1.1, showing that companies from civil law countries are more likely to have a higher level of IR disclosure quality compared to those from common law countries. These findings are in line with the notion of the civil law legal system being more stakeholder-oriented than common law. At the same time, they are consistent with the results obtained by Frias-Aceituno et al. (2013b), who demonstrated that firms located in civil law countries are more interested in disclosing integrated information than are those based in common law countries.

Our results partially confirm Hypothesis 1.2 as well, because they reveal that a difference (significant at the 5 % level) does exist between countries with strong and weak legal protection, at least with reference to the IIRC content elements. The direction is consistent with our expectations, since IR disclosure quality is more likely to be higher in countries with weaker investor protection, where the focus is not only on financial issues but rather extends also to social issues.

Similarly, we find support for Hypothesis 1.3, according to which companies from countries with stronger employment protection are more likely to produce a higher level of IR quality. Table 10.2 shows significant differences, in particular with respect to the content elements ($p < 0.01$ with t test and Wilcoxon test).

Overall, these results on our first set of hypotheses are consistent with the idea of IR disclosure quality being higher in contexts where the relevance of stakeholders is higher (thus in civil law countries and in contexts with higher employment protection and lower investor protection). Given the notion of IR being primarily a tool for investors, this evidence requires some consideration by standard setters, such as the IIRC.

Financial System

In Hypothesis 2.1, we suggested IR disclosure quality would be higher in countries with a higher degree of market orientation. Parametric and non-parametric tests support this hypothesis with a 99 % level of sig-

nificance. Therefore, we found evidence that market-based economies, which appreciate external and innovative forms of reporting to a greater extent than bank-based economies, exert some institutional pressure on companies to produce a high level of IR quality.

In Hypothesis 2.2, we proposed that companies from countries with higher ownership dispersion are more likely to produce a higher degree of IR quality. The results in Table 10.2 show that statistically significant differences exist ($p < 0.05$ with t test) but the direction is contrary to our expectations.

A possible explanation is related to the proxy used for measuring the degree of ownership concentration. In fact, following La Porta et al. (1998), this variable assesses the presence of the state among shareholders. Taking into account that some previous studies (see, Amran and Haniffa 2011; Gallo and Jones Christensen 2011; Tagesson et al. 2009) found that state-owned companies are associated with a higher extent of SR, we can consider the same effect for IR, assuming that these organizations are subject to more stringent reporting requirements and scrutiny, or because they are supposed to set a good example.

Educational and Labor System

As regards the educational and labor system, we find significant support ($p < 0.10$) for Hypothesis 3.1, providing evidence supporting a positive impact of the share of private expenditures for tertiary education on IR quality and for Hypothesis 3.2, showing that companies from countries with a high trade union density are more likely to disclose a higher quality of IR.

The result for Hypothesis 3.1 is particularly interesting, as it suggests that the level of intervention by companies in financing education is positively related to IR. Even if this is not a proxy for the overall quality of the education system, it is important to note that IR requires a certain level of educational background in order to develop. This education level does not refer only to people working for the reporting companies, but also to investors and to society in general. The information disclosed in

IR needs to be evaluated and used by knowledgeable investors and needs to be further refined and studied by academic scholars. From this perspective, IR is an educational-sensitive tool.

Cultural System

In Hypothesis 4, we proposed that national corporate responsibility has a positive impact on IR disclosure quality. Table 10.2 reveals that the differences are statistically significant ($p < 0.01$ with t test), at least with reference to the content elements. Therefore, in countries where companies are viewed as a responsibility-bearing part of society, there is more interest in disclosing information through IR.

This result is in line with those found for the influence of the legal system, showing that IR disclosure quality is higher in stakeholder-oriented contexts. Even though IR is mainly an investor-oriented tool, stakeholders still play a central role, as the IIRC Framework recognizes the importance of capitals and the relevance of stakeholder engagement. Therefore, companies that are more used to dialoguing with stakeholders are also more likely to provide better IR disclosure.

Economic System

Finally, Hypothesis 5 predicted a positive impact of the level of economic development on IR quality. Our findings support this hypothesis, showing significant differences notably for EFI. Thus, companies located in more developed countries seem to disclose a higher level of IR quality. This finding is interesting because it is in line with the idea of IR being more relevant in contexts where critical success factors are more linked with intangible assets (i.e. more developed economies). Reputation, trust, innovation and all the other intangible assets that allow companies to produce and sustain value over time will be even more important in more developed economies. Therefore, companies belonging to these contexts have higher incentives to provide a better representation of these capitals (and thus a higher IR disclosure quality).

Conclusions

This chapter aimed at studying whether and how the institutional context where a company operates influences IR disclosure quality. In order to answer our research question, we relied on a unique hand-collected dataset of IR disclosure quality.

Our results show strong empirical support for the hypothesis that a country's institutional characteristics significantly shape IR disclosure quality. In particular, we find that disclosure quality is higher in civil law countries and in countries with higher employee protection, levels of market coordination, ownership concentration, companies' involvement in education, density of trade unions, corporate social responsibility and economic development. Conversely, investor protection has a negative impact on IR disclosure quality.

This chapter contributes to previous literature on the determinants of IR (Frias-Aceituno et al. 2013a, b, 2014; Sierra-Garcia et al. 2013; Garcia-Sanchez et al. 2013; Jensen and Berg 2012) by introducing a new and more refined variable (IR disclosure quality) that allows us to draw new insights on the nature of IR and its relationship with the institutional context.

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11

Enterprise Risk Management and Integrated Reporting: Is There a Synergism?

Giorgio Bertinetti and Gloria Gardenal

Abstract Integrated Reporting (IR) and Enterprise Risk Management (ERM) are two ways that have to converge into the “integrated thinking” approach, as both of them push towards a new long-termism in management decisions. Risk management aims to protect company value, this way making the business sustainable over time; so risk issues should be well considered into the integrated report and, in the meantime, company providing the integrated report should demand for the existence of an ERM. Analyzing the companies of the IIRC Pilot Programme we find that: the number of companies filling the IR and contemporaneously adopting the ERM is increasing over time. However, shifting from the traditional to the integrated report doesn’t imply a simultaneous adjustment to an integrated risk management, but when both approaches are present companies have higher performances with respect to those that only do the IR. This evidence supports the hypothesis that ERM can be useful to make the integrated thinking effective.

G. Bertinetti (✉) • G. Gardenal
Department of Management, Ca’ Foscari University of Venice, Venice, Italy

Introduction

This Chapter investigates whether a link between the choice to adopt the Integrated Report (IR) and the adoption of an Enterprise Risk Management (ERM) approach exists.

The idea comes from the evidence that both IR and ERM appeared at the beginning of the new millennium and that their relevance has grown impressively in the last 15 years. This parallel dynamic has not been fortuitous: in our opinion it has been the result of the common dissatisfaction about the prevailing model and practice in firm management, the same dissatisfaction that is now bringing both practitioners and academicians toward the “integrated thinking”. If a common starting point exists, synergism opportunities must be present. If performance measurement looks for new elements and standards, so should risk management, as it has to “protect” company performances.

Focusing on ERM, where a comprehensive theory has not yet being developed, we investigate whether the awareness about the benefits of managing the company through “the lens of the integrated thinking”, that pushed companies to adopt the IR, also pushes companies to manage risks in a more efficient way.

Looking at Corporate Risks in an Integrated Way: The Enterprise Risk Management (ERM)

The Evidence of ERM Need

Despite risk has always been considered one of the main drivers in finance, together with return, not so many studies have been dedicated to enterprise risk management in the past, probably because of the dominance of the neoclassic model. That model, based on the studies about diversification (Markowitz 1952) and portfolio management (Sharpe 1964), states that firm specific risk profile is not relevant because investors can reduce it through diversification.

Many different events in the last 15 years provided evidence about the limit of that approach and the opportunity of managing risk at firm level:

- (a) the price bubble burst in 2000 showed that market perfection hypothesis of the neoclassic model is far from the existing situation; as a consequence, “its assumptions and its predictions/conclusions have no basis in the real world” (Fernandez 2015) and controlling risks at firm level could be useful;
- (b) firms are far from the static black-box implied in the neoclassic model. Big changes are taking place and a new winning type of firm is emerging, where human capital is more important than financial capital (Zingales 2000). So resignation of a key employee is a new kind of risk that companies have to avoid;
- (c) the adoption of the Kyoto Protocol in 2005 states that environment safeguard is a fundamental social principle. As a consequence, not managing the environmental impact of firm business may seriously damage company reputation and be very expensive, either in terms of sales reduction or of emerging costs as in the case of the BP oil spill in the Gulf of Mexico in 2010;
- (d) events like the Nike child labor gate in 2002 demonstrate how much customers are sensitive to ethical and social issues, once again asking for reputation risk control;
- (e) the growth of unemployment rate over 6 % almost in every European country in 2012, as a consequence of the world wide crisis, showed the social relevance of firm financial and economic sustainability. The whole social system can be damaged if companies take uncontrolled risks.

The evidence is that there are many different relevant risk profiles and also that the firm exposure to most of them should be evident in the IR. The problem is how to manage those risks; because they cannot be managed individually, they also need interdisciplinary competences and also a long-term approach. So, an integrated approach is needed, able to look simultaneously at them all, while also considering the correlation among them.

The Role Played by Recent Regulation

The above-mentioned emerging importance of ERM has been perceived also by authorities in many countries. Starting from the early 2000, regulators pushed companies to improve their risk management and reporting function and to adopt a new approach to risk management: the so called Enterprise Risk Management (ERM). As opposed to the Traditional Risk Management (TRM), where individual risk categories are managed separately in risk “silos”, the ERM allows firms to manage a wide array of risks in an integrated, enterprise-wide fashion (Hoyt and Liebenberg 2006). From a regulatory perspective, there are several examples of this tendency: the NYSE Corporate Governance Rules and the Sarbanes Oxley Act in the US; the Combined Code on Corporate Governance in the UK; the Dutch Corporate Governance Code, also known as the Tabaksblat Code; the Italian *Codice di Autodisciplina* for listed companies re-emended in 2011.

Several semi-regulatory bodies have published frameworks to guide organizations in their ERM design and implementation efforts. In 2004, e.g., the Committee of Sponsoring Organization of the Treadway Commission (COSO) released the Enterprise Risk Management Integrated Framework, which provides very broad guidance, suggesting key principles and concepts but leaving the details to the adopting organizations themselves. In the same year, the New York Stock Exchange (NYSE) issued new corporate governance rules requiring audit committees of listed firms to be more involved in risk oversight. These rules led many boards to require the review and approval of risk management by their audit committee. In October 2008, the Troubled Asset Relief Program (TARP), stemmed from the Emergency Economic Stabilization Act (EESA) with the purpose of helping troubled financial institutions, stipulated that participating firms have to certify that executive compensation programs do not encourage excessive risk taking. The year after (May 2009), the Shareholder Bill of Rights stated that public companies must create stand-alone risk committees comprised entirely of independent directors who are responsible for the establishment and evaluation of risk management practices. In February 2010, the Securities and Exchange

Commission (SEC) promoted new rules for an enhanced risk-related disclosure in proxy and annual statements, in particular with respect to the relationship of a company's compensation policies and practices to risk management and the board of director's leadership structure.

ERM has been targeted also by rating agencies. Since 2007, Standard and Poor's (S&P) has included a risk management rating as a key factor in its overall rating of insurance companies.

Existing Studies About ERM

Despite the increasing need and interest in risk management, comprehensive ERM theories do not exist and, as far as we know, there is no empirical research that systematically documents specific ERM practices and their contribution to ERM effectiveness. A possible reason is the difficulty in developing a reliable measure for the ERM construct. Some authors (Beasley et al. 2008; Hoyt and Liebenberg 2010) use the appointment of a chief risk officer (CRO) as a proxy for ERM implementation. Others (like Gordon et al. 2009) develop their own index.

Overall, the literature recognizes three fields of study. One stream of research examines the factors that influence the ERM adoption (Beasley et al. 2005; Kleffner et al. 2003; Liebenberg and Hoyt 2003). Other studies address the effects of ERM adoption on performance (Beasley et al. 2008; Gordon et al. 2009; Andersen and Roggi, 2012). Finally, another set of papers explores the details of risk management practices in specific organizational settings (Mikes 2009; Wahlström 2009; Woods 2009; Paape and Speklé 2012).

Results found so far show that: the implementation of ERM benefits firms by decreasing earnings and stock price volatility, increases capital efficiency, and creates synergies between different risk management activities (Miccolis and Shah 2000; Cumming and Hirtle 2001; Lam 2001; Meulbroek 2002; Beasley et al. 2008). Furthermore, the ERM adoption seems to promote increased risk awareness, which facilitates better operational and strategic decision-making. There is also evidence that the extent of ERM implementation is influenced by the regulatory

environment, internal factors, ownership structure and firm and industry-related characteristics (Paape and Speklé 2012).

ERM Applied Approach

Profit maximizing firms usually consider implementing an ERM program only if it increases expected shareholder wealth. The studies about risk management show that managing each risk class in separate silos creates inefficiencies due to lack of coordination between the various risk management departments. Supporters of ERM argue that by integrating decision-making across all risk classes, companies are able to avoid duplication of risk management expenditure by exploiting natural hedges. ERM should allow firms to better understand the aggregate risk inherent in different business activities, thus providing them with a more objective basis for resource allocation which implies improved capital efficiency and return on equity. Moreover, ERM provides a structure that combines all risk management activities into one integrated framework that facilitates the identification of potential interdependencies between risks across activities, which might go unnoticed in the TRM model. So, while individual risk management activities can reduce earnings volatility from a specific source (hazard risk, interest rate risk, etc.), an ERM strategy aims to reduce volatility by preventing aggregation of risk across different sources. Another great advantage of adopting ERM programs arises due to improved information about the firm's risk profile. (Meulbroek 2002).

Technically, the ERM is a process and, as such, it's not static but dynamic. Moreover, people belonging to all different levels of the organization should be involved in implementing it. It's not sufficient that the top management formalizes the guidelines about how to manage risks; it's important that every individual knows the risks of its operating unit, his/her responsibilities and, consequently, can have all instruments and tools to manage the complexity. The ERM not only allows individuals to identify, manage and control risks but it helps them contextualizing their tasks within the company: therefore, it allows developing the *integrated thinking* in the organization.

The ERM is crucial also in the definition of the corporate strategy. In fact, every organization, according to its mission and vision, defines its strategic objectives and, consequently, its strategy. In order to do it, the management should compare different strategic alternatives and evaluate the risks connected to each one; since the ERM defines the link between activities and risks, it is very useful in this phase.

The Enterprise Risk Management must be implemented throughout the company: every subject must evaluate the risks connected to a specific activity/project, function or operating unit he is in charge of, both in qualitative and quantitative terms. It will be a responsibility of the senior management to evaluate if the sum of the company risks doesn't exceed the maximum level of risk tolerance. The limit for risk tolerance, or risk appetite, is the maximum level of risk the company and its managers are willing to accept; it's not the result of a calculus but rather a judgment of the management.

The most widespread framework for the ERM, the COSO "Enterprise Risk Management-Integrated Framework" published in 2004, defines ERM as a:

...process, effected by an entity's board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives.

It summarizes well what we have just described so far. It has eight components and four objectives categories. It is an expansion of the COSO Internal Control-Integrated Framework published in 1992 and amended in 1994. The eight components are:

1. Internal Environment
2. Objective Setting
3. Event Identification
4. Risk Assessment
5. Risk Response
6. Control Activities

- 7. Information and Communication
- 8. Monitoring

The four objectives categories are:

1. Strategy—high-level goals, aligned with and supporting the organization’s mission
2. Operations—effective and efficient use of resources
3. Financial Reporting—reliability of operational and financial reporting
4. Compliance—compliance with applicable laws and regulations (Fig. 11.1)

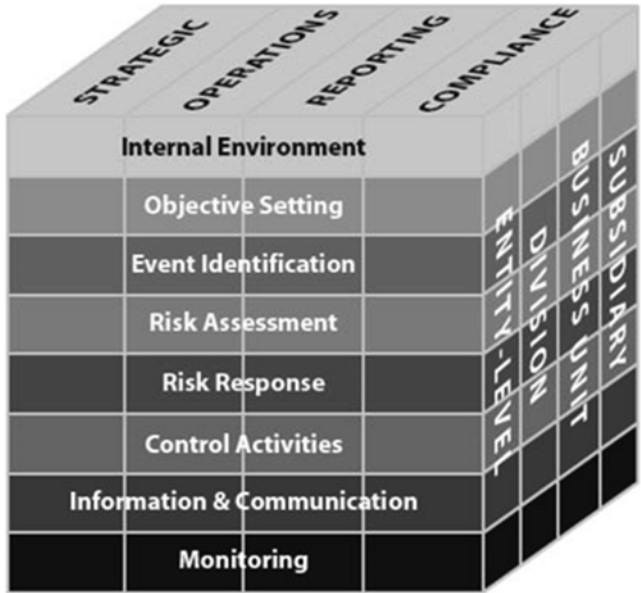


Fig. 11.1 ERM “cube” (COSO, 2004)
Source: Committee of Sponsoring Organizations (COSO), “Enterprise Risk Management - Integrated Framework: Executive Summary”

ERM E IR: Is There Any Relation?

Purpose of the Analysis

Given the purpose of this chapter, we performed a content analysis¹ on the integrated reports, annual reports and sustainability reports of the companies participating in the IIRC Pilot Program, on a time horizon going from 2009 to 2014.

The analysis is made of three parts: in the first part, we evaluate the quality of the integrated reports and the adoption of the integrated thinking; in the second part, we focus on the risk issue, on its relevance within the reports (either annual, sustainability and integrated) and on the presence of an ERM approach; finally, we test the presence of a relationship between the adoption of the IR and the ERM.

Dataset

The companies analyzed in this research are those listed on the IIRC website under the label *Pilot Program Business Network*. There are 104 organizations, categorized as: companies (86, 18 of which are banks and insurance companies), accounting professionals (11), regulators and other institutions (7). We decided to exclude from our analysis governmental bodies (like the CNDCEC, i.e. the Italian Association of the Accountants) and auditing companies (like KPMG and PricewaterhouseCoopers).²

The time horizon of our analysis covers the years 2009–2014. The Pilot Program started in 2011 but we decided to also consider the two previous years in order to identify the possible presence of the ERM independently of the adoption of the IR. Moreover, since we stopped collecting data in March 2014, when most of the companies hadn't released their

¹ The content analysis is “a wide and heterogeneous set of manual or computer-assisted techniques for contextualized interpretations of documents produced by communication processes in the strict sense of that phrase (any kind of text, written, iconic, multimedia, etc.) or signification processes (traces and artifacts), having as ultimate goal the production of valid and trustworthy inferences” (Tipaldo 2014).

² The list of the companies of the Business Network of the International Integrated Reporting Council is updated up to January 2015.

IRs yet (or their annual/sustainability reports), the information about 2014 is not complete and, for this reason, not reliable. Anyway, in what follows, we have reported also the data already public at that time.

The following figures represent the number and type of documents produced by our sampled companies per year: Fig. 11.2 reports the absolute numbers; Fig. 11.3 shows the incidence on the total of the documents produced. As we can see, there has been a positive growth from 2009 in the number of integrated reports released by the companies (and a progressive reduction in the number of sustainability and annual reports).

Before moving to the content analysis of these reports, it's important to clarify some methodological issues: many companies started to produce their IR under the label of "annual report" but declaring in the document to be following the principles indicated in the IIRC International Framework. Given this evidence, we considered those reports as integrated reports.

As our focus was not only on the IR but also on the ERM, we decided to perform the content analysis on all type of report produced by our sampled companies. For those producing the annual report together with the sustainability report, we have analyzed both documents, making a

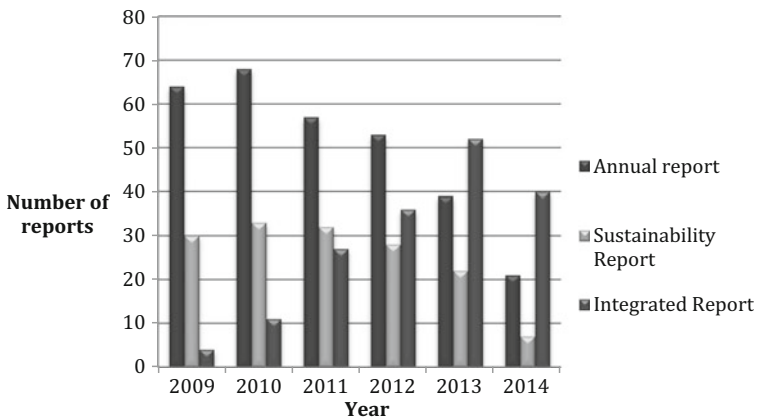


Fig. 11.2 Number and type of reports produced, per year
 Source: Personal Analysis

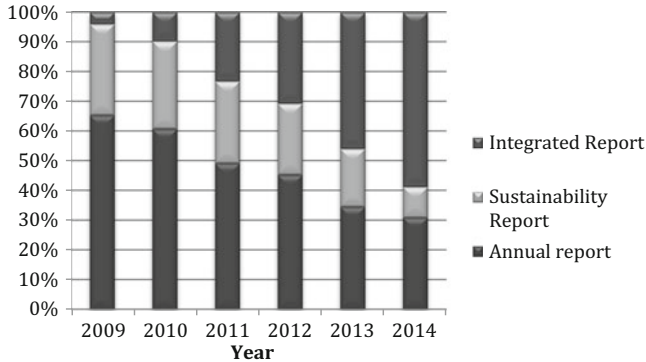


Fig. 11.3 Percentage of type of reports produced, per year

Source: Personal Analysis

comparison between the information contained in these documents and the IR.

In order to reach our research purposes, we used the software *Atlas.ti* to perform the content analysis on the reports of our sampled companies.

Analysis

First Part: Information Contained in IR

The first analysis we performed was on the content of the Integrated Reports (170 in total) produced by our companies in the considered time period in order to verify if they are comparable and if they contain all the items indicated in the guidelines of the IIRC.

To do that, we used the *Object Crawler* function of *Atlas.ti*, a function that indicates the presence of specific words in the documents considered. We searched for the content elements listed in the IIRC Framework, i.e. presentation of the organization and of the external environment, governance, business model, risks and opportunities, strategies and allocation of resources, performances and future perspectives. From this elaboration, we could create a database containing, for each report analyzed, the list of the elements present in the report.

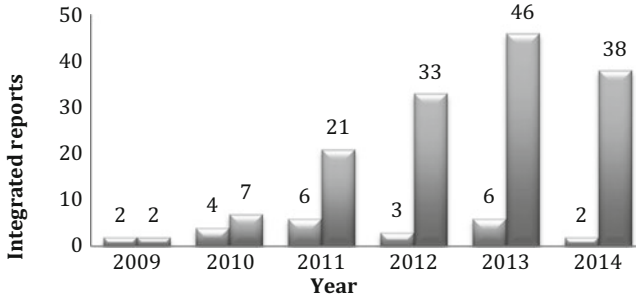


Fig. 11.4 Presence or absence of the business model description in the IRs, per year

Source: Personal Analysis

We discovered that the majority of the reports contain all the elements previously mentioned: 147 reports of 170 (86 %) present all the items; the remaining 23 reports (14 %) lack the description of the business model. As Fig. 11.4 shows, the companies omitting to present their business model are just a few and not the same, year after year. This evidence cannot be considered as negative but just part of the companies learning process in terms of Integrated Reporting (IR). In fact, from the first integrated reports to those produced in 2013, we see a strong enhancement in terms of quality and quantity of the information provided.

The same analysis was done with regard to the principle-based guidance of the IIRC. With respect to some guiding principles, as for example the *strategic focus*, the *orientation to the future*, the *relation with the stakeholders* and the *materiality*, we observe an evolution over time: organizations tend to involve more and more their stakeholders, being both external (i.e. stockholders) and internal (i.e. employees); the presentation of future objectives and of actions taken to pursue them are presented in a more extensive and clear way; the same holds for the materiality.

As far as the *conciseness* principle is concerned, we performed an analysis on the number of words in each of the reports considered. We used the function *World Cruncher*, whose output is a table containing the list of the words and their number for each report. We used that table to produce the results presented in Fig. 11.5. As we can see, the aver-

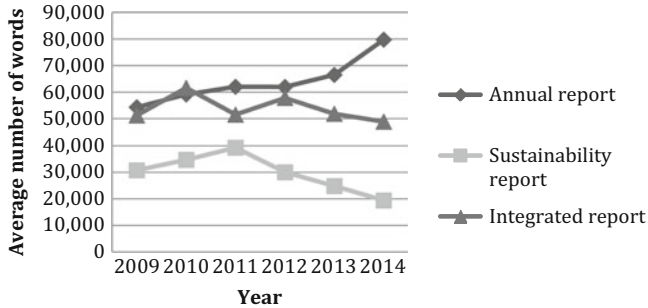


Fig. 11.5 Average number of words per type of report
 Source: Personal Analysis

age length³ of the integrated reports is lower with respect to the annual reports and it's decreasing over time.

We also made a focus on the phrase *Integrated Thinking* and we looked for how many companies are mentioning this new *modus operandi* in their reports. We found that only 18 companies use this phrase, providing a very synthetic description of it.

Second Part: Risk, Risk Management and ERM

In this paragraph, we focus our attention on the risk management topic and we map the evolution of the way in which it is disclosed to the stakeholders over time.

First of all, using the function *World Cruncher* of the software *Atlas.ti*, we counted the world “risk” and similar (e.g. “risky” and “riskiness”) in all the reports collected, in order to detect if the topic has become more crucial over time. Results are presented in Fig. 11.6.

Figure 11.6 shows an increasing tendency to disclose risk in the financial reports over time. Of course, there is a significant difference among the types of report considered. In the annual reports, the risk issue is disclosed only in the note to the financial statement (except for banks and

³We computed the average by the ratio between the total number of words in each report and the number of reports considered.

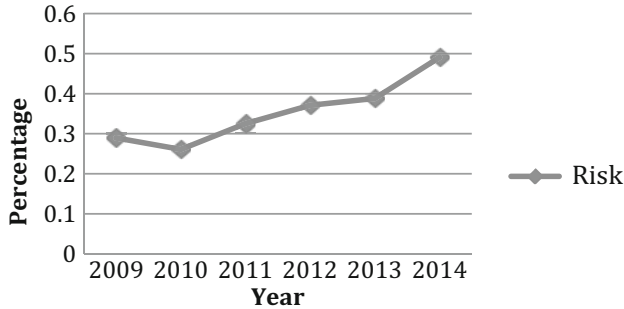


Fig. 11.6 The disclosure of risk over time
 Source: Personal Analysis

insurance companies, where managing risk is their core business) and it mainly contains the list of the risks the company is exposed to (i.e. market risks, credit risks, operating risks, etc.) and the hedging tools used. In the sustainability reports, the attention dedicated to the risk issue is higher and companies present an analytic evaluation of the environmental and social risk. In the integrated reports, the space dedicated to this issue is even bigger and companies tend to be very explicit in presenting their risk management model.

Analyzing the reports of the companies participating in the IIRC Pilot Program it turns out that: only 9 % of the sample describes the characteristics of their risk management process in their annual reports; 3 % in their sustainability reports and 41 % in their integrated reports: here companies mention who are the people involved in the risk management process and how they determine the material risks. In our sample, 37 companies out of 104 present in details their risk management model, mainly using graphic representations.

After that, we looked for evidence of the ERM adoption.⁴ To do that, we used the function *Autocoding* of the software *Atlas.ti*. Figure 11.7 and 11.8 report the number (and %) of companies declaring to use the ERM (IRM and EWRM were included in the search).⁵

⁴ Sometimes companies refer to the ERM using different expressions as integrated risk management (IRM) or enterprise-wide-risk-management (EWRM). We searched for ERM evidence in the annual reports, sustainability reports and integrated reports

⁵ We remind the reader that information about 2014 is incomplete.

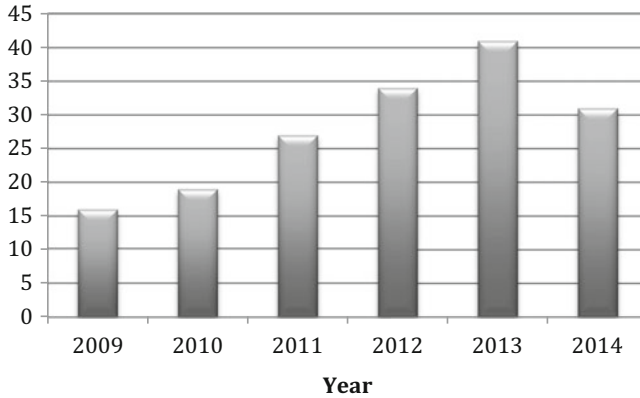


Fig. 11.7 Number of companies that adopt the ERM

Source: Personal Analysis

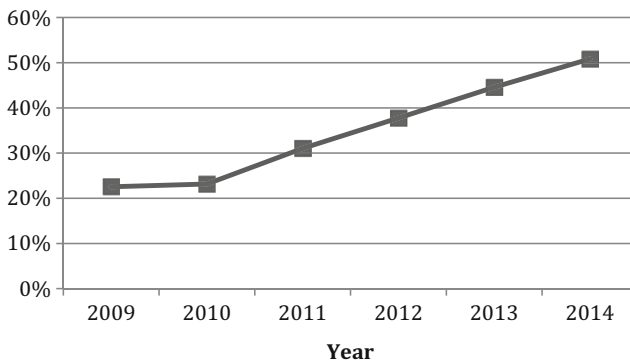


Fig. 11.8 Percentage of companies that adopt the ERM

Source: Personal Analysis

As we can see, there is an increasing rate of adoption of the ERM over time. We also tried to understand more deeply how the companies are approaching this new way to manage risks. Figure 11.9 and 11.10 propose an example of the definitions given to the ERM (ERM Definitions) in the various reports analyzed and of the quotes used to describe how it is implemented (ERM Implementation).⁶

⁶The numbers in brackets represent identification keys that the software atlas it attaches to specific words and documents. In reading the quotes they can be disregarded.

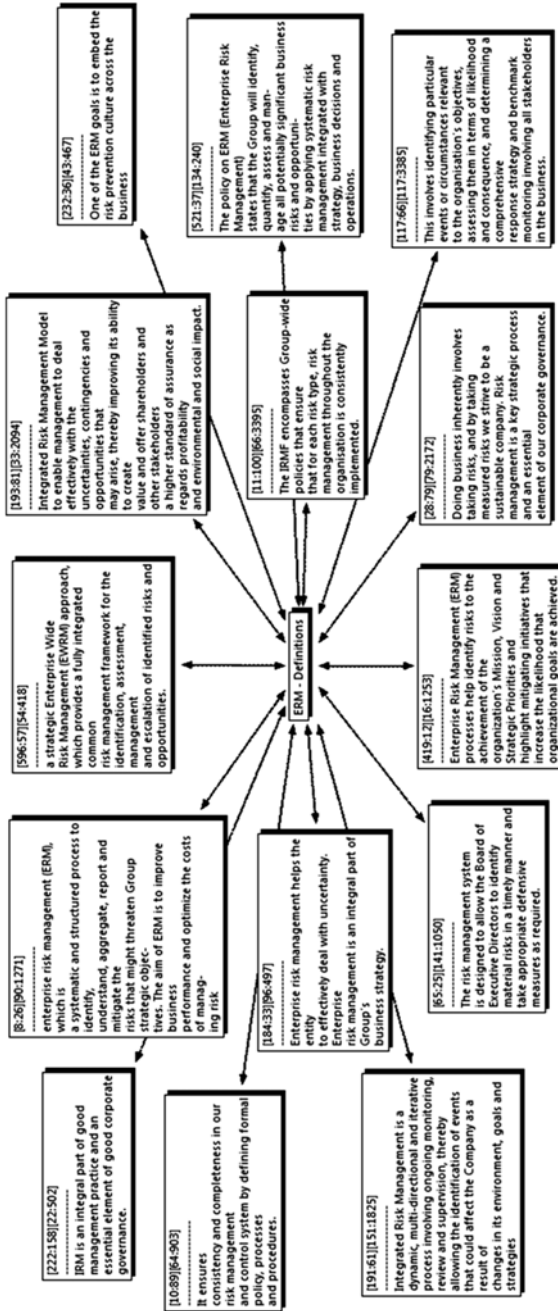


Fig. 11.9 Examples of ERM definitions
Source: Personal Analysis (output of the content analysis made on the company reports)

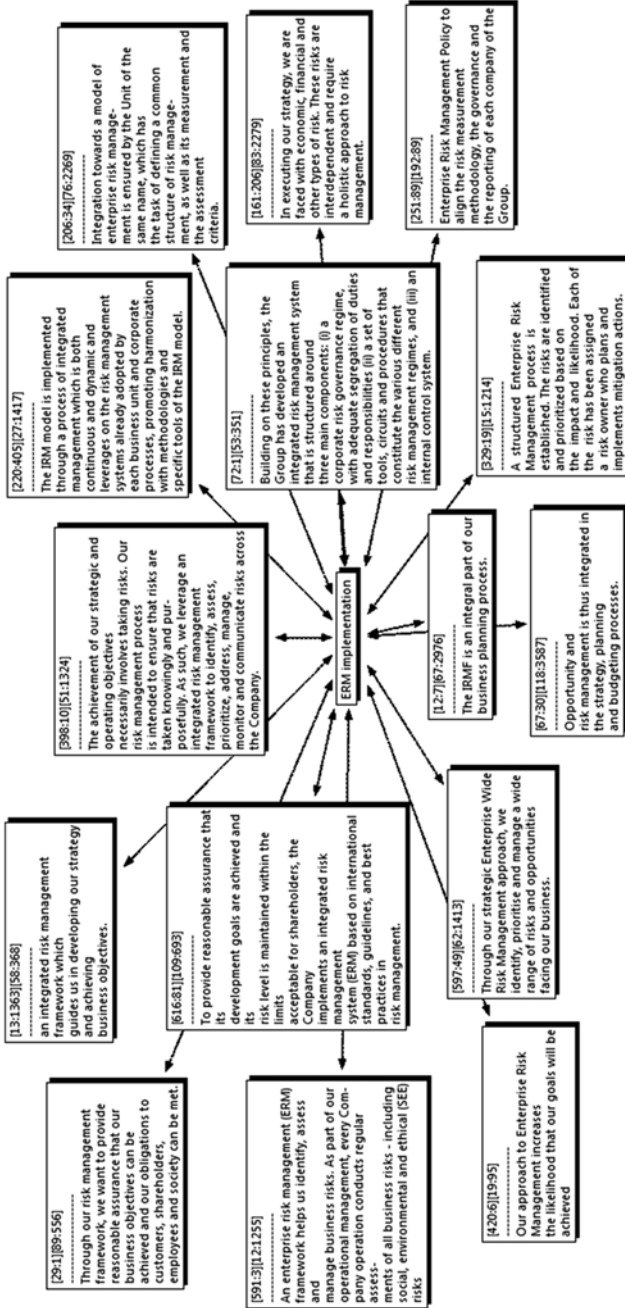


Fig. 11.10 Examples of quotes of how ERM is implemented
Source: Personal Analysis (output of the content analysis made on the company reports)

The analysis of definitions and implementations shows that there is homogeneity among companies in the elements they use to characterize the ERM. In some cases, we have also found an evolution of the concept over time. For example, Akzo Nobel, a Dutch multinational company specializing in the production of varnish and chemical products, in its 2011 report defines the ERM as a top-down process, giving the top management a central role in determining how to implement the ERM itself. However, in 2012, it defines the process as a bottom-up one, as it is suggested in the COSO Framework, showing that the idea that the risk management process should pervade all the organization is spreading. 11 companies in the sample explicitly mention the COSO Framework in their reports.

Another important element that characterizes the modern way to look at risk is to identify the opportunities that can stem from it. Figure 11.11 reports some quotes (taken from the reports of our sample). We found a total number of 21 companies (23 %) that provide this kind of information.

In order to evaluate how the companies are implementing the ERM, we looked for the presence of two important elements: the risk appetite (i.e.

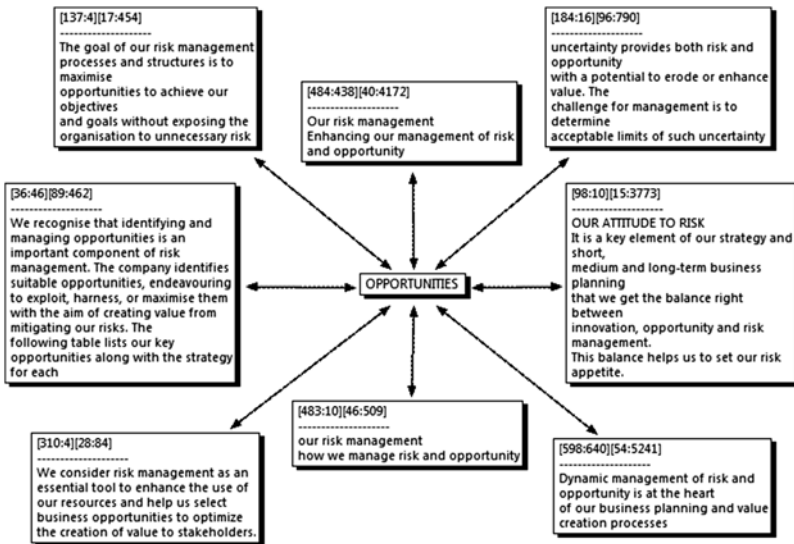


Fig. 11.11 Conceptual map of the quotes about opportunities
Source: Personal Analysis

the maximum amount of risk the company can tolerate) and the presence of a CRO (Chief Risk Officer). As far as the risk appetite is concerned, 44 companies claim that they systematically define it. They are both financial and non-financial companies. Instead, the presence of a CRO is often considered a clear signal of the presence of an ERM approach and that the company aims at efficiently manage risks. In our sample, only 19 companies (in 2013) mention the presence of a CRO, although around 40 declare to adopt the ERM in the same year, showing that ERM and CRO are not a “perfect couple” in our sample (see Figs. 11.12 and 11.13).

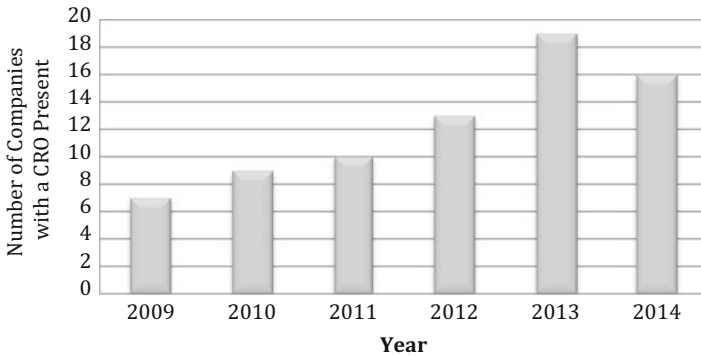


Fig. 11.12 CRO presence
 Source: Personal Analysis

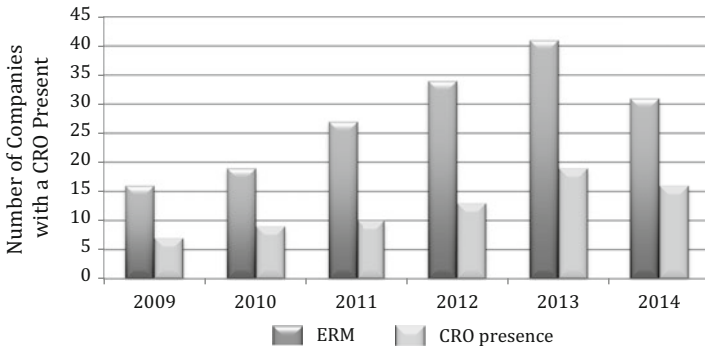


Fig. 11.13 Presence of the CRO Dark shade versus ERM Light shade
 Source: Personal Analysis

In order to evaluate the importance of the ERM for the companies, we have also considered the materiality matrices. Figure 11.14 and 11.15 provide two examples of companies that put the ERM in their materiality matrix. The first one is AB Volvo (IR 2014), for whom ERM has a medium importance and Votorantim (IR 2012), for whom the integrated management is very important but it's not the same for its stakeholders.

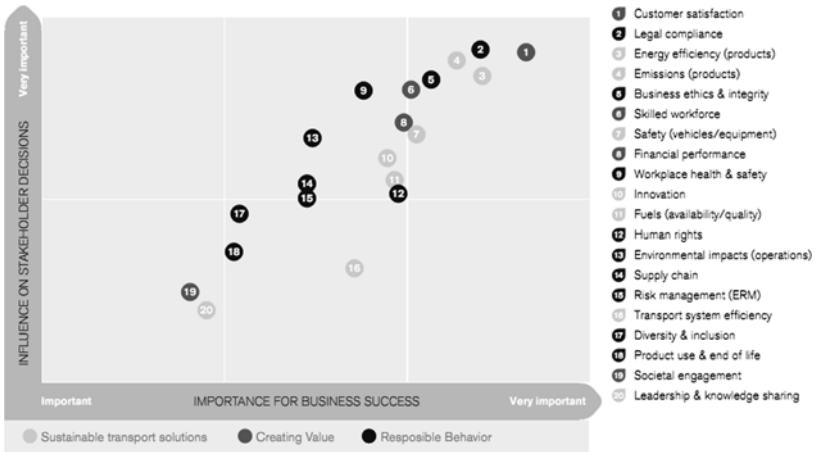


Fig. 11.14 Materiality matrix (AB Volvo, 2014)
 Source: Integrated Report of Volvo, 2014

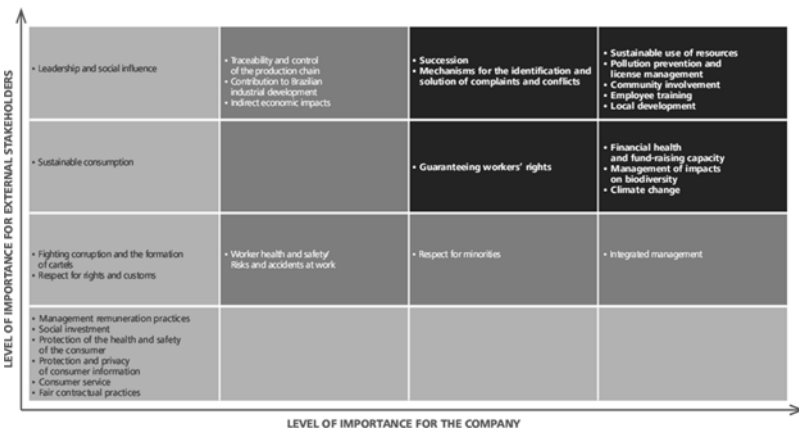


Fig. 11.15 Materiality matrix (Votorantim, 2012)
 Source: Integrated Report of Votorantim, 2012

Not all the companies of our sample present a materiality matrix. Only 37 have it: six of them include the risk management among their material elements; ten mention specific types of risk (e.g. climate change, technological risk, etc.); the remaining 21 don't mention risk at all.

Finally, we tried to detect a possible relation between ERM and IR. What we want to understand is if the IR pushed companies to consider more extensively the risk management issue or if the ERM adoption made companies look for a more effective way to disclose their performance and value drivers (as the IR does).

Table 11.1 and Fig. 11.16 summarize the information about the two topics in our sample, over time.

First, it's interesting to observe (Fig. 11.15) that the number of companies that fill the IR and contemporaneously adopt the ERM is increasing over time, above all between 2012 and 2013 (Table 11.2).

Table 11.1 ERM and IR in our sample, per year

Year	Total companies	Companies with ERM	% on the total n. of companies	Companies with IR	% on the total n. of companies	Companies with IR and ERM	% on the total n. of companies
2009	71	16	23	4	6	2	3
2010	82	19	27	11	15	4	6
2011	87	27	38	27	38	9	13
2012	90	34	48	36	51	14	20
2013	92	41	58	52	73	26	37
2014	61	31	44	40	56	25	35

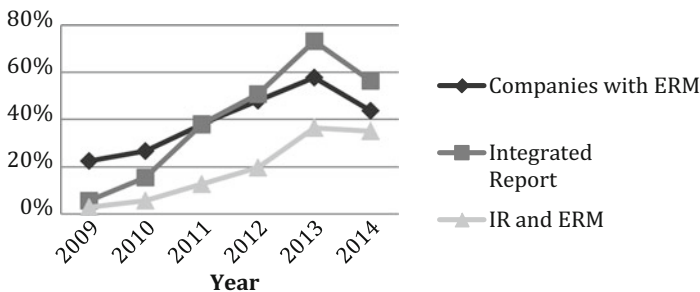


Fig. 11.16 Comparison between companies with ERM, IR and both (on the total sample)

Source: Personal Analysis

Table 11.2 Variation of the IR/ERM/both adoption over time

Year	Com-panies with ERM		% on the total n. of com-panies		Variation wrt previous year (%)		Com-panies with IR		% on the total n. of com-panies		Variation wrt previous year (%)		Com-panies with IR and ERM		% on the total n. of com-panies		Variation wrt previous year (%)	
	Total com-panies	with ERM	com-panies	of com-panies	wrt previous year (%)	with IR	with IR	with IR	with IR	with IR and ERM	with IR and ERM	wrt previous year (%)	with IR and ERM	with IR and ERM	with IR and ERM	with IR and ERM	wrt previous year (%)	
2009	71	16	23	4	4	4	6	2	3	3	10	2	3	2	3	3	3	3
2010	82	19	27	11	4	11	15	4	6	6	10	4	6	4	6	6	6	3
2011	87	27	38	27	11	27	38	9	13	13	23	9	13	9	13	13	13	7
2012	90	34	48	36	10	36	51	14	20	20	13	14	14	14	20	20	20	7
2013	92	41	58	52	10	52	73	26	37	37	23	26	26	26	37	37	37	17
2014	61	31	44	40	-14	40	56	25	35	35	-17	25	25	25	35	35	35	-1

However, if we compare the variation over time of the IR adoption and of the ERM implementation, we observe that the first one is systematically higher with respect to the latter. This means that, while companies are investing energies in producing the IR, they are not simultaneously adopting the ERM at the same “speed”.

If we now restrict our attention only on the companies that produced the integrated reports in the time period considered, and we see how many of them also adopted the ERM, again we get the same conclusion: shifting from the traditional report to the integrated report doesn't imply a simultaneous adjustment; however, there is an increasing trend (Fig. 11.17) (Table 11.3).

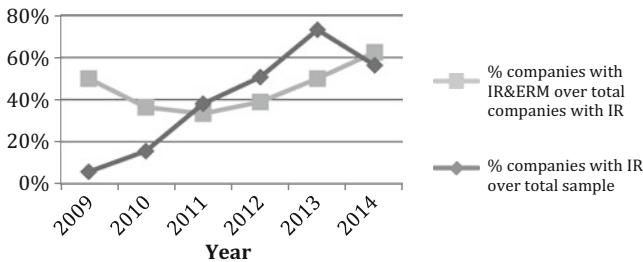


Fig. 11.17 The ERM in the companies producing the IR

Source: Personal Analysis

Table 11.3 The ERM in the companies producing the IR

Year	Companies with IR	% on the total n. of companies	Variation wrt Previous year (%)	Companies with IR and ERM	% Companies with IR and ERM over tot. number of companies with IR	Variation wrt Previous year (%)
2009	4	6		2	50	
2010	11	15	10	4	36	-14
2011	27	38	23	9	33	-3
2012	36	51	13	14	39	6
2013	52	73	23	26	50	11
2014	40	56	-17	25	63	13

Conclusions

In the last 15 years companies have become more aware of the need to identify all the possible value drivers in order to be profitable and to survive to the negative shocks in the economy. This awareness brought, on one side, the need of a new way to represent performances in terms of both financial and other value relevant information: the Integrated Report. The IR provides greater context for performance data, clarifies how value relevant information fits into operations or a business, and may help embed long-termism into company decision making, thus facilitating “integrated thinking”. On the other side, the risk management function went through a “revolution”: the traditional approach “by silos”, using insurance and financial derivatives, proved ineffective. This led to the rise of a new approach to risk management: the Enterprise Risk Management. ERM helps to avoid duplication of risk management expenditure by exploiting natural hedges. It also allows firms to better understand the aggregate risk inherit in different business activities, thus providing them with a more objective basis for resource allocation which implies improved capital efficiency and return on equity. Moreover, it provides a structure that combines all risk management activities into one integrated framework that facilitates the identification of potential interdependencies between risks across activities.

Given the integrated nature of IR and ERM, we looked for a possible synergism between the two and we discovered that the companies participating in the IIRC Pilot Program are increasingly adopting the ERM in addition, even if not at the same speed. However, those who adopt both approaches have higher performances with respect to those that only do the IR, showing that ERM can be the proper tool to make integrated thinking effective.

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12

The Integrated Reporting and the Conference Calls Content

Elisa Cavezzali, Nazim Hussain, and Ugo Rigoni

Abstract In this chapter we carry out a fact-based study and answer two main yet unanswered research questions: first, whether and how the adoption of Integrated Reporting (IR) affects the sustainability communication with the market through the channel of conference calls; second, to what extent financial market participants ask for sustainability information when they are in direct dialogue with firms. To answer these questions we analyse the conference calls' transcripts of firms that have adopted IR framework. Our findings reveal that the sustainability issues are not commonly addressed during the conference calls of IR adopters. This is particularly true while analysing the Q&A session of the call. The probable reason for this evidence comes from the market since the sustainability dimension of information merits a very low level of analysts' interest. Overall, our empirical evidence supports the dynamic perspective of the International Integrated Reporting Council Framework.

E. Cavezzali (✉) • N. Hussain • U. Rigoni
Department of Management, Ca' Foscari University of Venice, Venice, Italy

The Disclosure to the Financial Markets: Role and Features of Conference Calls

The Conference Calls for the Financial Markets

Information asymmetry exists when investors are differentially informed about firm value. Full disclosure helps firms reduce information asymmetry (Martínez-Ferrero et al. 2015). Superior quality disclosure about firm's operating policies smoothes the market participants' assessment of cash flows variance (Lambert et al. 2007), which resultantly decreases cost of financing (Dhaliwal et al. 2012).

Company's disclosure can assume different forms. Firms could release their financial and non-financial information through the mandatory disclosure that requires financial reports, including the financial statements and other regulatory filings, or engage in the voluntary disclosure, such as management forecasts, conference calls, press releases and other corporate reports. A great part of research has investigated both the quantity and quality of information released during the earnings conference calls that are a voluntary disclosure tool and allow firms to summarize and disseminate a large amount of information that otherwise would likely have been privately discovered and traded on later.

Briefly, conference calls are periodic (often quarterly) company events spread throughout the year, during which the top management, usually the CFO and CEO, present projections and the forward looking information to the investors. The conference call event is usually organized into two phases: the Managerial Discussion or Presentation part and the Q&A Session. The registration of calls, as well as their transcripts, are often made available online on the company's websites or in commercial databases.

Conference calls, together with press releases, websites and other business reports, are the most common form of voluntary disclosure used by listed companies. Conference call utilization has increased substantially since the implementation of Regulation Fair Disclosure (Reg FD), rendering them the second most utilized tool of voluntary disclosure behind earnings releases, at least in the US market (NIRI 2004).

Most importantly, investors pay great attention to conference calls. Trading volumes and stock returns are highly affected by these events (Frankel et al. 1999; Bowen et al. 2002; Bushee et al. 2003, 2004).

Conference calls are one of the successful ways to disseminate important information to the desired audiences. They differ from other tools of “traditional” communication both for their mode of execution, nature and consequences of the information disclosed. Conference calls are organized for specific audiences while other media of communication are used to provide information to wider variety of stakeholders. Despite the availability of information in credible sources (for example, financial reports and press releases), such information is not easily understandable by investors (Luo et al. 2015). As documented by the literature, institutional investors and analysts are keen to participate in conference calls to access to specific segments of information and details not disclosed in other releases, such as long-term forecasts for instance, available on request during the Q&A Session (e.g. Frankel et al. 1999). The existence of this session may explain why conference calls are not incorporated within the press releases. Companies prefer conference calls to other informative tools when they are not sure about the specific information needs of investors: the flexibility of the Q&A Session would enable stakeholders and analysts to gather all the necessary information, improving the predictive capability of financial analysts measured by their forecast errors and their dispersion (Bowen et al. 2002). In addition, conference calls would be preferred as held in a less formal atmosphere and according to less strict rules than those imposed for mandatory financial statements (Frankel et al. 1999).

Because of the features described above, conference calls represent an appropriate example of the dynamic perspective embraced by this book (see Chap. 2). Conference calls are not simply a means of disclosure. While websites, business reports or press releases aim to satisfy investors’ information needs (static approach), conference calls go further. In line with the dynamic IIRC approach, conference calls, through their Q&A sessions, allow the interaction and the dialogue between companies and stakeholders to happen. In other words, conference calls are “dynamic” by their nature.

The Conference Calls and Their Content

The quantity and quality of information released during earnings conference calls has been widely investigated in prior research (for example, Huang et al. 2014; Matsumoto et al. 2011; Price et al. 2012; Davis 2012). Previous literature mainly analyses the content of the conference calls in terms of length, tone or signals launched to the financial markets.

However, despite the recognition that sustainability information is value relevant, no research has considered the sustainability issues within the conference calls, as the finance environment has recognized the relevance of the environmental, social and governance (ESG) issues just recently. In 2004 the UN Global Compact introduced a set of recommendations grouped under the phrase “Who Cares Wins” to attract the attention of investors and analysts to include ESG information in their analysis, wealth management and trading operations (UNGC and PRI 2004). Before that, much of the financial activity had focused only on investments labelled as “socially [or ethical] responsible investments”. Only with “Who Cares Wins” and the UNEP Finance Initiatives the new ESG paradigm emerged: investors and analysts started to assess companies and their actions also in relation to their ESG performance, both in qualitative and quantitative terms.

Years after the start of these initiatives, the results collected indicate that both the participant companies and institutions agree that ESG factors are value relevant, but they also realize that neither the management nor the investors are able to fully incorporate them in their evaluation process (UNEP Financial Initiative and World Business Council for Sustainable Development 2012). To fully integrate sustainability into financial markets, companies need to incorporate environmental, social and governance (ESG) details into all communication (written and spoken) with investors. However, even though companies invest much time and resources in sustainability reporting, investors often find the information gleaned from these documents still difficult to interpret for business valuation. Therefore, the results indicate a gap between the perceived importance of reporting on sustainability and the actual disclosure and usability of it. As said earlier, conference calls are important windows for management and financial analysts to express their opinion about

the firm. As Eccles and Serafeim state, if the Integrated Reporting (IR) provides a useful framework for companies to express their sustainable strategy, the conference calls should represent the appropriate vehicle to communicate, discuss and convince the market about the relevance of a sustainable strategy (Eccles and Serafeim 2013). We agree on this statement, but we also add that as IR Framework focuses on capitals (instead of stakeholders) and therefore should be judged as an evolution of financial rather than sustainability reporting (EY 2014), earnings conference calls of IR adopters should mirror the same approach and focus on the “organization’s ability to create value over the short, medium and long term” (IIRC 2013), not on the disclosure of sustainability issues.

Therefore, we agree that the communication of the sustainability value drivers beyond the written communication needs to be improved, but we also believe that this is not achieved by simply adding pieces of information.

The UN Global Compact and the Principles for Responsible Investment are both aware of this and launched “The ESG Investor Briefing Project” conceived “to improve company-investors communications on material, social and corporate governance (ESG) information” (UNGC and PRI, 3 September 2013¹). According to the UN Global Compact guidelines, the briefing content should focus on sustainability as an integral part of business strategy.

Levels of IR Adoption and Conference Call Contents

The Selected IR Adopters

Annual reports and the earnings conference calls are the two most important tools to report on the company’s performance. The Integrated Report adoption choice clearly shows the company commitment to integrate sustainability in the financial reporting according to the “capitals” approach we stressed above. The analysis of the conference calls of these

¹ See *infra* Sect. 7.2.1.

companies allows us to understand in more depth the company aim of introducing the IR and its interest in the dynamic response of the market. If the aim is driven mainly by the “capitals” approach we don’t expect to find a relevant relationship between the level of IR adoption and the sustainability content of conference calls.

We focused our investigation on a selected set of IR reporters. According to our selection rule, we collected a list of 98 companies issuing at least one Integrated Report from 2011 to 2014 from the “Integrated reporting examples” database (<http://examples.integratedreporting.org>). This database offers examples of emerging practices in IR and therefore is a reliable and up-to-date source of information on IR adopters.²

The lack of mandated frameworks for the integrated communication implies that at present IR emerging practices shows differences in the implementation of the International Integrated Reporting Council (IIRC) IR’s framework.³ This variability guarantees a certain level of heterogeneity for the purpose of this analysis.

Table 12.1 summarizes some frequencies of the IR reporters of the dataset, grouped by industry (Panel A) and geographical area (Panel B) over years.

According to numbers, the IR implementation status varies around the world. The Financial services is the most active industry in terms of emerging practices in IR reporting, followed by the basic materials and the consumer goods industries. As for countries, Europe is at the first place in the ranking of emerging practices in IR reporting, followed by Africa, even though quite far from first position.

²This database is a joint project between the International Integrated Reporting Council (IIRC) and the Black Sun. plc. It collects selected examples of emerging practices in Integrated Reporting aiming to provide a support to organizations that are developing, or planning to develop, an Integrated Report. The example reports have been selected from publicly available reports written in English and the dataset is continuously updated.

³Just as a remainder, an Integrated Report should contain the following content elements: organizational overview and external environment, business model, risk and opportunities, strategy and resource allocation, governance, performance, outlook and basis of presentation. Each content should be informed to the suggested guiding principles. In the IIRC framework, these latter ones are seven: strategic focus and future orientation, connectivity of information, stakeholder relationships, materiality, conciseness, reliability and completeness, consistency and reliability. Furthermore, the Integrated Report framework should be underpinned by two fundamental concepts: the organization value creation and capitals.

Table 12.1 The IR reporters*Panel A—the IR reporters
by industry*

Industry	No. of companies	No. Integrated Reports issued				
		2011	2012	2013	2014	Total
Basic materials	14	11	1	5	1	18
Consumer goods	13	7	3	7	1	18
Consumer services	10	0	3	6	3	12
Financial services	19	10	4	8	4	26
Healthcare	6	4	2	2	1	9
Industrials	12	4	4	7	2	17
Oil and gas	7	3	1	4	3	11
Professional services	2	0	2	1	0	3
Public sector	1	0	0	1	0	1
Real estate	2	2	0	1	1	4
Technology	2	1	0	0	1	2
Telecommunications	2	2	1	1	0	4
Utilities	8	2	3	4	1	10
Total	98	46	24	47	18	135

*Panel B—the IR reporters
by region*

Region	No. of companies	No. Integrated Reports issued				
		2011	2012	2013	2014	Total
Africa	16	13	5	6	1	25
Asia	15	1	3	10	4	18
Australasia	4	3	2	1	1	7
Europe	49	21	11	24	12	68
North America	8	3	3	3	0	9
South America	6	5	0	3	0	8
Total	98	46	24	47	18	135

The Integrated Content of the Conference Calls

The ESG Investor Briefing Project

The IIRC or other initiatives (for example, the SASB and SASB Materiality Map) offer useful frameworks and standards for companies to prepare the written information to disclose and for investors to understand and compare the information received. This is not so valid for the conference call

mechanism. The lack of guidelines and formats for the communication through this channel could make it challenging for companies to disclose effectively about their sustainable strategies and policies and for investors to collect this information.

The recent and on-going ESG Investor Briefing Project is an initiative attempting to provide a structured approach for ESG communication with investors. It offers a baseline model for the analyst calls based on the quarterly earnings calls. Specifically, the project invites companies to hold ESG Investor Briefings, as separate company events to the traditional quarterly earnings calls.

The Briefings should specifically present the link between the ESG company commitment, the business strategy and the shareholder value creation to a target audience—the mainstream investors. During the event, companies should not restrict themselves to report the general ESG strategy, but discuss how these strategies and performance translate into financial value and prioritize the communication of ESG issues.

The proposed format of the conference call plans an approximate duration of 60 minutes (including the Q&A section) and the participation of CEO, CFO or board members to emphasize the strategic nature of the sustainability commitment of the company. Head of Sustainability/CSR and Investor Relations should actively participate in the preparation of the call while the Investor Relator is appointed to the presentation.

As for the conference content, the project proposes specific guidelines. The Briefing should focus on the sustainable strategies pursued, summarizing the company sustainability investment in an initial short executive statement. Companies should also illustrate a mix of both quantitative and qualitative information, presenting recent or projected sustainability initiatives, products or services and how they relate to the company's key financial metrics. In order to underline the financial impact of the sustainability investment case, companies should use a standardized model, the ESG Value Driver Model,⁴ an open model helping in communicating the business value of sustainability to investors. In particular the model helps

⁴The model has been developed by a Zurich-based ESG consultancy firm and derived from previous academic works developed by Kaplan and Norton (2008), Porter and van der Linde (1995), Esty and Winston (2005), Lubin and Esty (2010).

companies in constructing their own metrics underlining the connection between the top financial objectives (for instance, return on capital or return on equity) and the sustainability effects, such as: revenues growth from sustainability-advantaged products, services and/or strategies, total annual cost savings (and cost avoidance) from sustainability-driven productivity initiatives, reduced sustainability-related risk exposure that could materially impair a company's performance (UNGC and PRI 2013).

To this day, just seven companies have joined the project. SAP was the first firm to host a sustainability conference call in 2012, after the launch of the project. Then, also ENEL, Pirelli, Eni, Nors Hydro, CLP Holdings joined the programme hosting one ESG Briefing each in 2013, while BBVA in 2014. In the future, this new conference call framework could be an evolution of the earnings conference calls, mirroring the evolution of the IR approach with the financial reporting.

The IR Reporters' Conference Calls

Surveys show clear signs of the growing importance of communication between corporates and investors on ESG issues; the ESG Investor Briefing Project is still too new and little known to enable a large number of companies to benefit from the new communication framework. Whether and how the Investor Relations officers are currently communicating the ESG performance to investors are still unresolved issues. We investigate these dynamics examining the current conference call mechanisms.

To analyse the sustainability content of information provided in conference calls we apply a content analysis to a set of 889 conference call transcripts⁵ collected from Bloomberg and made available for 70 companies out of 98 initially selected.⁶ In order to test whether the IR adopters' conference calls are not focusing on sustainability information, we apply a structured approach to the issue. Therefore, we build a disclosure taxonomy based on 108 sustainability keywords⁷ and we count the number

⁵We include quarterly, half year and annual conference calls.

⁶Some companies were or went private while for some others no conference call transcripts were available.

⁷We applied the "stemmed words" approach that allows for checking words with the same stem.

Table 12.2 The sustainability disclosure content of the conference calls

Sustainability dimension	No. of items	Keyword counting	Conference calls	
			No. (total 889)	%
Economic	27	678	412	46.34
Environmental	32	1102	486	54.67
Social	49	1293	677	76.15

of “sustainability” words used during the conference calls held two years before and two after the IR fiscal year. Our expectation is to find the use of sustainability words, but not extensive and predominant, especially during the interacting moments of the conference calls.

For this purpose, our taxonomy is built according to two main sources: the Global Reporting Initiative (GRI) standards⁸ and the World’s Business Reporting Network (WICI) classification system.⁹ This allows us to make our analysis more reliable and less sensitive to the specificity of data used.

The Integrated Disclosure in the Earnings Conference Calls

At a first glance, the companies analysed disclose their sustainability commitment. Searching for “sustainable” and “sustainability” words, we found that 68 companies use at least one of these words, recurring 347 times and 1571 times in the total conference calls transcripts.

However, a more in-depth analysis produces further insights arise.

Table 12.2 reports synthetically the findings achieved, categorizing the items used along three sustainability dimensions: the economic (27 items), environmental (32 items) and social (49 items) one. Since our aim was specifically to investigate the sustainability aspects raised during the conference calls, we used a short list of economic keywords, limiting our selection just to those words more connected to the sustainable features of the economic dimension.

⁸<https://www.globalreporting.org/standards/g4/Pages/default.aspx>.

⁹<http://www.wici-global.com/framework>.

The “Keyword counting” column indicates the frequency of the items researched in the transcript document, while the “Conference Calls” columns report the number and the percentages of the conference calls where the items have been detected.

Our evidence shows that the sustainable part of the economic dimension is discussed in less than half of our conference calls. The most recurring items are in the following order: “sanctions/fines”, “value creation”, “economic growth”, “infrastructure investments”, “sustainable development”. These items are used by a variable number of companies between 20 % and 53 % of the total dataset.

As for the environmental dimension, more than half of the conference calls (54.67 %) mentioned terms of this category such as “Emissions of Carbon, Gas, Co2, So2, GHG, H2S, Nox” (280 times in the 13.08 % of conference call transcripts), “Renewable/Renewable Energy” (271 times in the 8.66 % of conference call transcripts), “Reuse, Recycle” (136 times in the 6.41 % of conference call transcripts). With regard to the social aspects of the sustainability, the 76.15 % of conference calls deals with this topic, recurring in particular terms such as “wage” and “remuneration” (242 and 294 times in 15 % and 9 % of the conference calls of 55.72 % and 40 % of the companies, respectively), “training costs/hours” (used 199 times in 13 % of conference calls and 65.71 % companies). Other words, such as “life insurance”, “health care” or “local community”, have a lower frequency (57, 38, 19 times, respectively) and few conference calls contain these words.

Even though the frequencies for the three dimensions are different, the different numbers of the words used for each dimension mainly explains such differences. In fact, the ratio between the keyword counting and the number of items is similar, being 25 (678/27), 34.47 (1102/32), 26.39 (1293/49) respectively for the economic, environmental and social dimension.

We then investigated how the different level of adoption of IR by companies relates to the sustainability disclosure level of conference calls. We measure the level of IR adoption looking at the company application of the guiding principles suggested by the IIRC framework. We create an index (*GP_INDICATOR*) as the average number of guiding principles applied by each company to the content elements used in their IRs. We relate this indicator to measures of conference call sustainability dis-

closure, captured by three different indexes built for each sustainability dimension: an economic indicator (*ECO_DISCLOSURE*), that calculates the percentage of economic items disclosed with respect to the total sustainability items detected in the conference calls, an environmental indicator (*ENVIR_DISCLOSURE*) revealing the environmental item use with respect to the total and a social indicator (*SOC_DISCLOSURE*) measuring the percentage of social items with respect to the total sustainability words used. Each indicator calculates the percentage of items of the sustainability dimension with respect to the total sustainability items.

According to the *GP_INDICATOR* level, Figure 12.1 allows the clear distinction of two clusters of IR adopters: the IR “advanced” adopters and the “basic” ones. The first group includes companies strongly committed to the IR implementation while the second one shows a lower level of IR framework adoption.

The interesting evidence is that for both clusters it is not possible to detect any particular features identifying different sustainability disclosure policies. In line with our expectations then, both the “advanced” and “basic” adopters show similar patterns in their sustainability disclosure. This is particularly true for the economic dimension of the sustainability. Only slight differences can be distinguished in the disclosure of the environmental and social dimensions, but the level of the disclosure indicators are rather low in any case. Therefore, we can conclude that, regardless of the IR adoption level, companies show similar strategies in the sustainability disclosure during their conference calls. In other words, companies engaged in the voluntary disclosure of sustainability information through the IR approach, are following the same strategy in the voluntary disclosure through the conference calls.

The Tone of the Disclosure

As for the tone of the sustainability information provided during the conference calls, we investigated whether the meaning of the words mentioned was positive or negative. As expected, in almost all the queries there is a predominance of positive connotation. This is evident in particular by looking at the words that by their nature have negative connotation, especially those words that represent the environmental impact: consumption, emissions, pollution. It is important to consider the tone as it shows what message

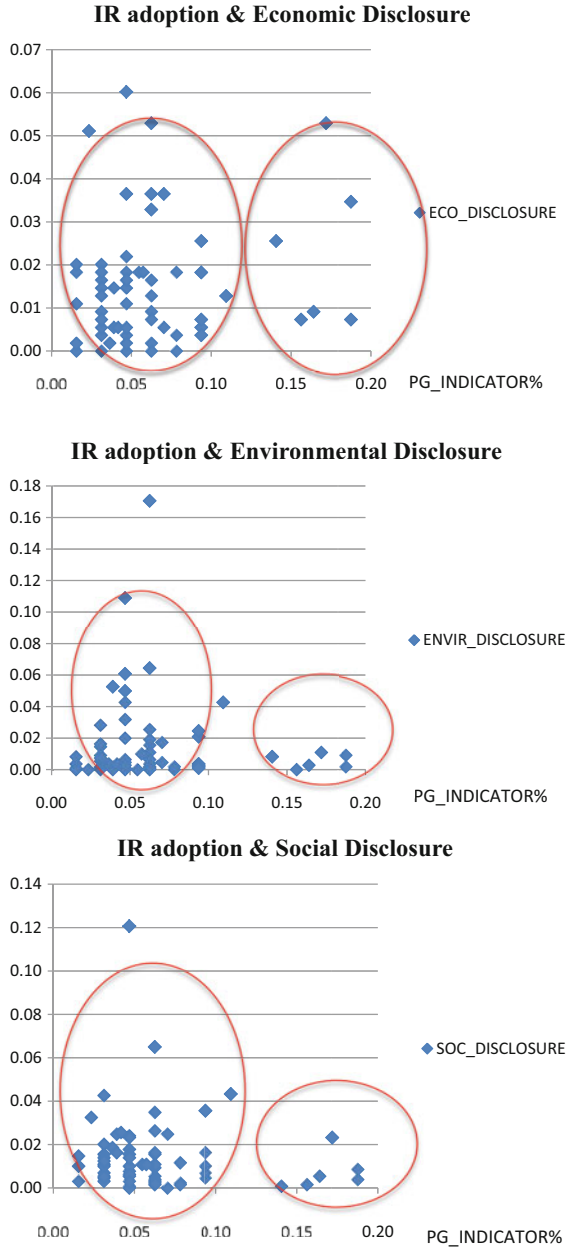


Fig. 12.1 The IR adoption and the sustainability content of the conference calls

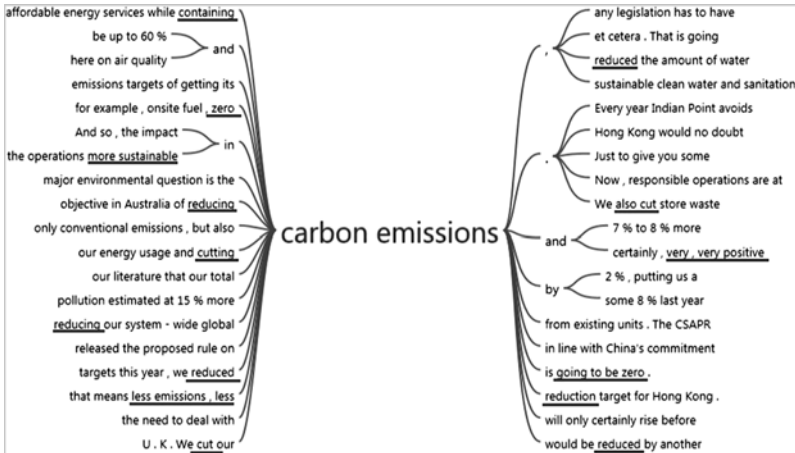


Fig. 12.2 The “Word Tree” for the keyword “Carbon Emissions”

management wants to convey to the audience at this event. Plumlee et al. (2015) recently analysed the tone of sustainability disclosure and its impact on investors’ perception and by analysing the impact of good/bad and soft/hard disclosure tone. This implies that firms want to send a positive signal to the market in the case of superior sustainability performance and “greenwash” in the case of inferior performance (Adams 2004). Greenwashing helps firms maintaining a positive image in society even when they do not perform well (Greer and Bruno 1996). The existing research in this vein also yields similar results. Mahoney et al. (2013), note that firms disclose positive information with the objective that this provided information should be extrapolated as a commitment towards better social and environmental performance. They further argue that stakeholders reward positive social and environmental performance. Parallel to these findings some others argue that firms do not have any specific objective of fulfilling the information needs of stakeholders. For example, Husillos et al. (2011) study the emergence of triple bottom reporting in Spain and conclude that the firms are disclosing sustainability information not because they are being asked by the stakeholders but firms are trapped in isomorphism. Similarly, Amran and Haniffa (2011) reveal that all the three mechanisms of isomorphism prevail in the Malaysian economy i.e. coercive, norma-

tive and mimetic. Many others in different countries have reported similar results. But the results are not yet conclusive and call for more in-depth investigation about the value relevance of sustainability information (Hahn and Kühnen 2013).

These facts motivate our in-depth analysis of direct corporate communication with its investors and analysts. Figures 12.2, 12.3 and 12.4 are

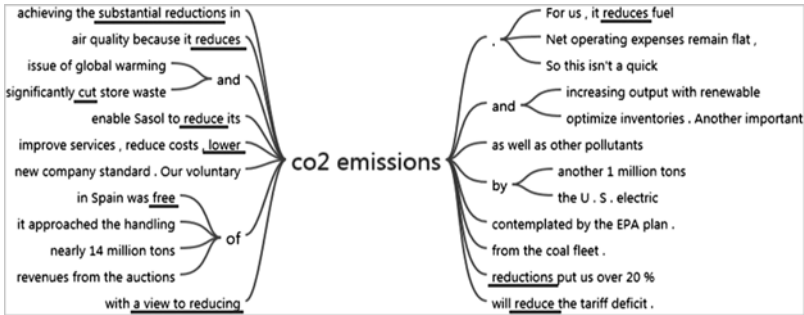


Fig. 12.3 The “Word Tree” for the keyword “Co2 Emissions”

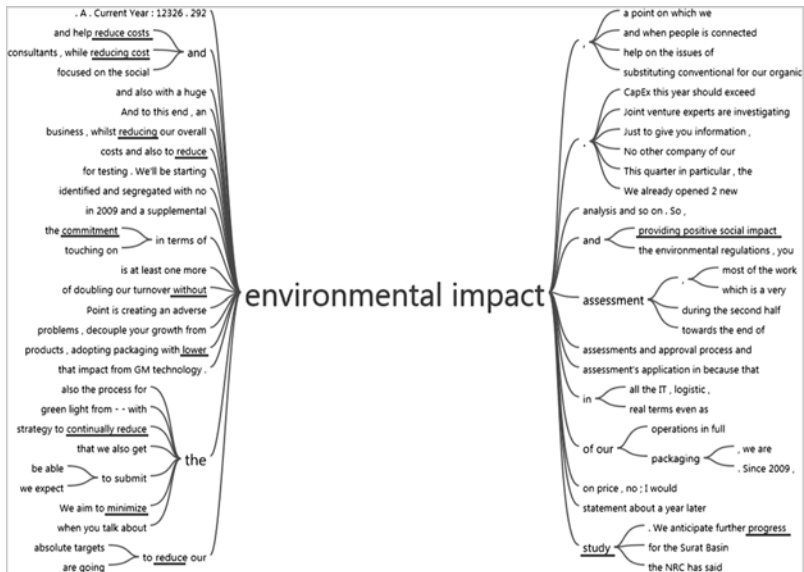


Fig. 12.4 The “Word Tree” for the keyword “Environmental Impact”

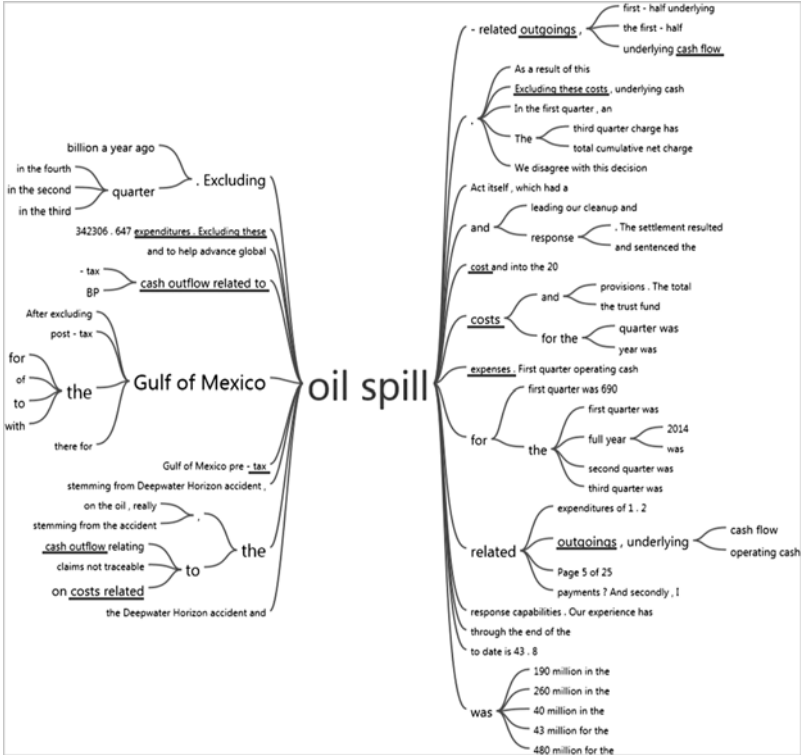


Fig. 12.5 The “Word Tree” for the keyword “Oil Spill”

helpful and illustrative examples of the “Word Tree”¹⁰ for some of these words. Each single image is photographing and crossing the sentences containing the keyword searched.

An interesting result is about the business related item “Oil Spill” that has been mentioned 45 times by just one company, out of the eleven ones belonging to the Oil industry of the dataset. All the connections to this item are referring to the 2010 disaster of British Petroleum firm in the Gulf of Mexico and from which arose the potential economic impacts

¹⁰ The Word Tree is a visual and information-retrieval technique to explore text documents. A Word Tree is a graphical and interactive version of the traditional “keyword-in-context” method and depicts parallel sequences of words. In our case this tool can be useful to detect which words most often follow or precede the target word.

Table 12.3 The sustainability content in each conference call session

Sustainability dimension	Presentation session	Q&A session*
Economic	62.61 %	37.39 % (9.57 %)
Environmental	77.00 %	23.00 % (4.75 %)
Social	74.67 %	25.33 % (5.33 %)
Average	71.43 %	28.57 % (7.123 %)

*Frequencies in parenthesis represent the items coming from direct analysts' questions

in terms of cost and future cash flows (Fig. 12.5). Some of the words in 'word tree' are underlined to show that how firms are using the negative connoted words positively.

The disclosure in the Q&A session

Hosting a conference call instead of simply issuing an earnings press release offers an important occasion to companies: the discussion session with analysts. However, what section of the conference calls provides the most informative content and what role analysts play in the company information disclosure are still unresolved issues in prior literature (see for example, Matsumoto et al. 2011; Mayew and Venkatachalam 2012; Price et al. 2012) and the sustainability aspects of the interaction between managers and analysts are unexplored as yet.

Our analysis offers some insights on the sustainability informative content of the Q&A session of the conference calls. Our aim was to understand whether the sustainability argument was raised directly from the analyst or was provided by the CEO/IR officers during their presentation or as an answer to a generic question.

Table 12.3 reports a synthetic image of our analysis. The first column indicates the frequencies of sustainability items disclosed during the presentation session, while the second column reports the frequencies of sustainability words used during the Q&A session. The figures in parenthesis specify how many sustainability items have been mentioned in direct questions made by analysts.

Our evidence arises at least two relevant points. First, that the greater part of the sustainability words have been used during the presentation session where CEOs and/or Investor Relations officers show their willingness to prepare statements and arguments addressing these specific issues. Second, that during the Q&A session, the interest on sustainability issues shows a sharp drop. The average number of sustainability information provided during the presentation session is about 70 %, but it decreases to less than 30 % in the Q&A session. Furthermore, the quantity of sustainability information required directly by analysts to CEOs/IR officers is almost irrelevant (7 % on average). This is an interesting point because it shows that there is not a strong pressure from analysts to disclose sustainability information. The greatest interest, even though low, showed by analysts is towards the economic dimension of the sustainability. The social and the environmental classes count a very low level of analysts' interest. This remark is also reinforced by the fact that part of the few items mentioned in the analysts' questions and referred to environmental and social aspects (such as "Life insurance" or "Health care") is used to indicate the corporate business and not the sustainability commitment and strategy impact.

This empirical evidence confirms more systematically the anecdotic result of Eccles and Serafeim (2013) for SAP's earnings conference calls. Although SAP is a company clearly committed in a sustainable strategy and practicing the IR, during its conference calls the sustainability subject went unmentioned.

Overall, our findings are in line with our expectations and show that the sustainability issues are not commonly addressed during the conference calls of IR adopters, as demonstrated by the low number of sustainability words spent. This is particularly true while analysing the Q&A session of the call. In line with Eccles and Serafeim (2013) our results contest the existing arguments of increased pressure for sustainability information disclosure. Previously, Kiernan (1998) argue that market analysts use environmental performance information as a predictor of future returns. Our empirical evidence contest these arguments by analysing the direct communication between companies and financial analysts and show that analysts are least interested in such information.

The low numbers of sustainability items recorded in the analysts' questions during the conference calls indicate that no pressure comes from

the market to provide this kind of information. Therefore, companies do not disclose them simply because they are not required. This is in line and confirms the dynamic perspective of the IIRC Framework. Furthermore, these results are also in line with the Campbell and Slack (2011) evidence who interviewed 19 UK based sell-side analysts and report that none of the analysts incorporate sustainability performance information for the preparation of their recommendations. Differently from their conclusions, we argue that the reason could be related to the lack of analysts' interest in specific sustainability issues.

As raised by Eccles and Serafeim, there is a “chicken-and-egg” problem here. Companies complain that analysts never ask questions about sustainability, so why should they bother talking about it? Analysts' and investors' response is that...since the company isn't talking about sustainability, it must be because it really doesn't think it's all that important. So why should they ask about it? (Eccles and Serafeim 2013, p. 16).

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13

The Relationship Between Integrated Reporting and Cost of Capital

Nelson Carvalho and Fernando Dal-Ri Murcia

Abstract In this chapter, we address the relationship between Integrated Reporting (IR) and cost of capital. By examining the existing accounting, finance and sustainability literature we argue that there is a negative relationship between IR and the cost of capital, i.e. IR should lower the company's cost of debt and equity in the medium and long terms. In our view, these effects derive from two main factors: (i) the adoption of a sustainable business model due to integrated thinking and (ii) an information asymmetry reduction caused by greater transparency, allowing more informed forecasts both leading to positive returns to investors and creditors in the long term.

Introduction

This chapter addresses the relationship between Integrated Reporting (IR) and cost of capital. By examining the existing accounting, finance and sustainability literature we argue that IR should lower the company's cost of debt and equity in the medium and long terms.

N. Carvalho (✉) • F.D.-R. Murcia
Universidade de São Paulo, São Paulo, Brazil

This expected reduction in the company's cost of capital derives from two different effects brought by IR: (i) the adoption of a sustainable business model due to integrated thinking and (ii) an information asymmetry reduction caused by greater transparency, allowing more informed forecasts.

Firstly, IR derives from Integrated Thinking, which 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. As Integrated Thinking leads to integrated decision-making and actions that consider the creation of value, it makes companies more sustainable over time.

Thus, companies that embrace IR should be able to tailor their business models to respond to external environments, both threats and opportunities. In other words, these companies should be able to adapt themselves better to the demands for greater sustainability, which will come from different stakeholders over time.

Secondly, IR reduces the information asymmetry between the company and its stakeholders. That is because IR contains more relevant information (holistic approach) than conventional financial reporting; therefore, it increases corporate transparency. In this sense, investors and creditors have increased information to take better decisions to allocate economic resources regarding the future of the company; and this increased information affects the price of securities.

Thus, as the transparency brought by IR is much higher and broader than conventional financial reporting, we should expect companies that adopt and disclose performance and expected cash flows under the IR Framework to have lower cost of capital in the medium and long term.

In the following sections, we develop further these arguments by reviewing the existing accounting, finance and sustainability literature.

This chapter explores those arguments by reviewing the existing accounting, finance and sustainability literature. Although there have been several papers that studied the link between sustainability and finance, none has yet theoretically or empirically analyzed the relationship between IR and cost of capital. Therefore, this chapter intends to present an innovative contribution to academics and practitioners.

We believe that studying the economic effects of IR is relevant because rational decision-makers will only fully embrace IR once they perceive

benefits in doing so. Following this rationale, academic research could help promote IR by studying the economic effects of its adoption. Cost of capital reduction (lower interest rates in borrowing and larger price-per-share in securities) provides the funding that motivates entrepreneurs to invest—and investing in assets, in financing working capital, in plants and equipment generates jobs and allows companies to seek increased revenues and profits. This may prove to be a major benefit that provides significant incentives to corporations to adopt IR in the future.

In this sense, this chapter contributes to existing literature by addressing a very relevant “practical” issue—the relationship between IR and cost of capital—that has not yet been fully addressed by previous research.

The Impact of Information Asymmetry on the Cost of Capital

Information asymmetry occurs when one party has more or better information than the other, which creates problems like adverse selection and moral hazard. The paper “The Market for Lemons: Quality Uncertainty and the Market Mechanism” by the economist George Akerlof (1970), who received the Nobel Prize in Economic Sciences in 2001, is considered a seminal work in information asymmetry and its impact on the market. His main thesis was that information asymmetry leads to “the bad driving out the good” in the market.

Akerlof (1970) used the market for used cars as an example of the problem of information asymmetry and adverse selection. In that market, there are good used cars and bad used cars (“lemons”), normally as a consequence of several not-always-traceable variables, such as the owner’s driving style, quality and frequency of maintenance, accident history etc. In the presence of information asymmetry, buyers cannot differentiate good cars from “lemons” so their best guess for a given car is the average quality.

Due to that, buyers will be willing to pay for any car only the price of a car of known average quality. This means that the owner of a carefully maintained good used car will be unable to get a high enough price to make selling that car worthwhile.

In capital markets the same problem occurs. In the presence of high levels of information asymmetry, capital providers (investors and creditors) cannot differentiate good companies from “lemons”. In this scenario, capital providers will seek to protect themselves against possible losses resulted from trading with better informed agents by lowering the price at which they are willing to pay or increasing the price at which they are willing to sell a security.

According to Welker (1995), in the absence of information, investors seek protection against the problem of adverse selection by lowering the price they are willing to pay for the security, which reduces the possibility of negotiation and consequently the liquidity of shares.

For Brown and Hillegeist (2007), this form of price protection in the negotiation process introduces a differential between the price offered and the price demanded in the market, which is often known as the “bid-ask spread”. The higher the bid-ask spread, the lower the liquidity of a security.

Thus, information asymmetry affects market liquidity. Moreover, liquidity is an important factor for capital providers as they can trade their positions more rapidly and without concessions. Consequently, because capital providers value liquidity, less liquid stocks will trade at a discount.

According to Verrecchia (2001), investors anticipate the future price protection, due to higher levels of information asymmetry, and will reduce the prices they are willing to pay for the company’s shares. Similarly, a buyer would offer a lower price for a car if he expects to have difficulties to sell it in the future due to market illiquidity.

Therefore, information asymmetry will cause illiquidity that in turn will lead to higher cost of capital. According to Botosan (1997), the cost of capital is higher for stocks with higher bid-ask spread because investors demand additional compensation due to the higher transaction costs. For Hail (2002) investors prefer stocks with lower transaction costs when making investments. In this sense, investors will charge a premium to fund companies with illiquid stocks.

Lack of information also leads to higher cost of capital due to higher risk perceived (or feared) by capital providers. This is because information asymmetry leads to moral hazard, as the behavior of those who control the company cannot be completely observed (Holmstron 1979).

In the presence of asymmetry, managers can use their insider information to maximize their own interests at the expense of investors and creditors. According to Beaver (1998), acts of moral hazard do not only involve accounting fraud and earnings management, but any action other than the best interest of investors, for example, such as taking greater risks on projects. Thus, lack of transparency increases the risk of expropriation.

Also, information asymmetry leads to higher levels of uncertainty about the true parameters of a company's future returns (Botosan 1997). According to Hail (2002), investors prefer stocks with a lower level of uncertainty about future returns and distributions, which translates into lower risk. The rationale is that lack of information generates uncertainty that in turn leads to volatility.

In this scenario, a rational investor who is aware of its informational disadvantage to managers, will only choose to invest in a company if his uncertainties are reduced to a satisfactory level, or if they are rewarded for taking the risks arising from lack of information (charging a premium to allocate funds under uncertainty) (Baums 2002). The higher the information asymmetry, the more likely it is that investors will ask for a risk premium as a reward for allocating capital to companies under incomplete information (Merton 1987).

In conclusion, information asymmetry generates problems like adverse selection and moral hazard, which decrease security's liquidity and increases the perceived risk of an investment. The immediate response is an increase in the return demanded by investors and creditors. For companies, that outcome represents a higher cost of capital.

Transparency, Integrated Reporting and Information Asymmetry

Greater transparency that comes with IR will reduce the levels of information asymmetry in the market leading to lower cost of capital for companies. This argument derives from the following reasons.

First, the more transparent a company is the more difficult and more expensive to get private information; soon, there will be fewer investors with insider information (Leuz and Wysocki 2008).

The transparency that comes with IR is expected to reduce uncertainty about the company's value, which consequently reduces the informational advantage that the most informed investors have. Overall, increased transparency will tend to reduce the price protection imposed by uninformed investors, generating more liquidity for the shares in the market and thus reducing the cost of capital for the company.

The availability of information that reduces the uncertainty of investors about the company's future results will also mitigate the risk of investors making bad decisions (Bushman and Smith 2001). From this perspective, IR will help investors to make better investments decisions.

In fact, improving investment decisions is the main purpose of IR, as stated in The International IR Framework (2013a, p. 7):

1.7 The primary purpose of an integrated report is to explain to providers of financial capital how an organization creates value over time. It therefore contains relevant information, both financial and other.

Also, IR will allow capital providers to understand the organization's strategy, its business model as well as how it creates value over time. In fact, this is one of the guiding principles in the preparation of an Integrated Report, called the "Strategic focus and future orientation," which is also stated in the International IR Framework (2013a, p. 5):

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.

In this sense, IR will assist investors in the risk/return evaluation and consequently reduce their required rate for an investment. This is because transparency and better information can decrease the cost of capital by reducing the risk estimation, which can be considered non-diversifiable.

Transparency can also mitigate the effects of the moral hazard problem, because it makes the actions of managers more visible to capital providers, functioning as an important control mechanism. Thus, IR has an important monitoring role, which is also stated in The International IR Framework (2013a, p. 2), as "<IR > also aims to:

Enhance accountability and stewardship for the broad base of capitals (financial, manufactured, intellectual, human, social and relationship, and natural) and promote understanding of their interdependencies.

In this sense, IR has a corporate governance function as it allows a more accurate judgment of the agent's (manager's) performance. Consequently, managers will be more accountable for their actions and will tend to invest less in projects that destroy (or diminish) the company's value. In this scenario, by investing in better projects that generate better returns, a company becomes more profitable; and thus will have a lower cost of capital.

Because IR is still in its infancy, we were not able to find any studies that had investigated the relationship between the increased level of disclosure brought by IR and cost of capital. However, there is vast literature on the relationship of higher levels of disclosure and cost of capital. Table 13.1 below presents a brief description of these studies.

Sustainability, Integrated Reporting and the Cost of Capital

Sustainable development, as first stated by the United Nations (1987) in convening the Brundtland report "Our Common Future", refers to development that "meets the needs of the present without compromising the ability of future generations to meet their own needs".

Since then, the concepts of "sustainable development", and "sustainability", have gained importance. Nowadays, it is widely accepted that the effects of economy activity on the environment and on future generations should be somehow measured, recognized and disclosed to society.

Overall, corporate stakeholders have become more concerned with damages to the environment, and therefore expect to be informed about social and environmental corporate practices. According to Labatt and White (2002), concerns with the environment have grown, probably due to the problems related to global warming, leading to a greater demand from society for corporate responses to issues that were not considered previously.

Baron (2014) presents a list of issues that companies commonly address as part of responsibilities going beyond compliance with national and international legislation:

Table 13.1 Prior studies on corporate disclosure and cost of capital

Authors—journal	Description of the study
Botosan (1997)— <i>Accounting Review</i>	Examined the association between disclosure level and the cost of equity capital by regressing firm-specific equity cost capital and a measure of disclosure level. Manufacturing firms in the US market composed her sample. Her findings provide evidence that for firms with low analyst following, greater disclosure is associated with lower cost of capital
Sengupta (1998)— <i>Accounting Review</i>	Investigated the link between a firm's overall disclosure quality and its cost of debt financing. His sample was composed of firms in the US market. His results provide evidence that firms with high disclosure quality ratings from financial analysts enjoy a lower effective interest cost of issuing debt
Hail (2002)— <i>European Accounting Review</i>	Examined the relationship between voluntary disclosure policy and cost of equity capital, computed using a residual income model. His sample was composed of 73 non-financial firms in the Swiss market. His results reveal a negative and highly significant association between the voluntary disclosure and cost of capital. The magnitude is such that the most forthcoming firms enjoy about a 1.9 % cost advantage over the least forthcoming firms
Lopes and Alencar (2010)— <i>The International Journal of Accounting</i>	Replicated the work of Botosan (1997) using a sample of companies from the Brazilian market. Results confirm their hypothesis. Disclosure is strongly associated with ex ante cost of equity capital, and are more pronounced for firms with less analyst coverage and low ownership concentration
Dhaliwal et al. (2011)— <i>Accounting Review</i>	Examined if the initiation of voluntary disclosure of corporate social responsibility (CSR) activities affects the cost of equity capital. Their results show that firms with high cost of equity capital in the previous year tend to initiate disclosure of CSR activities in the current year, and that initiating firms with superior CSR enjoy a subsequent reduction in cost of capital and attract dedicated institutional investor and analyst coverage.

- Resource efficiency (energy, water and land use and management, other materials);
- Release of regulated and unregulated pollutants (e.g. greenhouse gases);
- Production of hazardous waste;

- Impacts on biodiversity and ecosystem services;
- Sourcing of materials (e.g. the use of conflict minerals, trafficking), certification;
- Use of green products in production and environmental performance of products;
- Corruption;
- Human rights;
- Health and safety;
- Employment, labor conditions, training, gender balance, turnover rate (talent management and retention);
- Communication with stakeholders (investors, suppliers, customers, employees, non-governmental organizations, authorities, communities);
- Corporate governance (e.g. composition of the board of directors, communication with stakeholders, executive compensation).

This sustainable development vision has led to the concept of “Socially Responsible Investing—SRI,” which is focused on investment strategies that consider, along with economic and financial analysis, environmental performance factors, social and corporate governance.

In the capital markets, the demand for Socially Responsible Investments has led to the creation of several sustainable Stock Indexes like the Dow Jones Sustainability Indexes, the FTSE4Good Series, the Johannesburg Stock Exchange SRI Index and the BMF BOVESPA Sustainability Index (“ISE”).

The financial sub-prime crisis has also raised questions about the sustainability of corporations. Regulators, governments, academics are debating on how can we make the financial system more robust, more sustainable. Many commentators defend that companies should have a more sustainable approach toward profits, focusing in the medium and long-term, instead of trying to beat the next quarter earnings per share— a short-time perspective.

Capital providers have also started to privilege and encourage companies to think about sustainable growth. A sustainable approach to investing is already been pursued by some of the largest investment funds in the World, like BlackRock. A letter sent by BlackRock’s Chairman and CEO

Mr. Laurence Fink in March of 2014, encourages Chairman and CEOs of companies to focus on long-term growth strategies:

Dear Chairman or CEO,

(...) To meet our clients' needs, we believe the companies we invest in should similarly be focused on achieving sustainable returns over the longer term.

(...) Corporate leaders can play their part by persuasively communicating their company's long-term strategy for growth. They must set the stage to attract the patient capital they seek: explaining to investors what drives real value, how and when far-sighted investments will deliver returns, and, perhaps most importantly, what metrics shareholders should use to assess their management team's success over time.

(...) We do recognize the balance that must be achieved to drive near-term performance while simultaneously making those investments—in innovation and product enhancements, capital and plant equipment, employee development, and internal controls and technology—that will sustain growth.

(...) We ask that you help us, and other shareholders, to understand the investments you are making to deliver the sustainable, long-term returns on which our clients depend and in which we seek to support you.

In this scenario, IR plays a key role assisting to direct funds to sustainable corporations, as stated by The International IR Framework—Basis for Conclusion (2013b, p. 6):

helps direct financial capital to sustainable businesses; a sustainable planet and a stable economy require sustainable businesses that support broader societal interests by undertaking long term, as well as short and medium term, value creation within planetary limits and societal expectations.

According to Eccles and Saltzman (2011), IR aims to demonstrate the organization's value creation capacity over time, which is intended to guide long-term investors on their decisions, by identifying the strategies, risks, opportunities and future prospects, not just focusing on the financial aspect, but considering other variables as well.

For Serafeim (2014), IR comes as a response to criticisms that disconnected Financial and Sustainability Reports are not effective in describing the long-term value creation process inside the organization.

In fact, IR derives from Integrated Thinking, which 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. According to the International IR Framework, (2013a, p. 2):

Integrated thinking takes into account the connectivity and interdependencies between the range of factors that affect an organization's ability to create value over time, including:

- The capitals that the organization uses or affects, and the critical interdependencies, including tradeoffs, between them;
- The capacity of the organization to respond to key stakeholders' legitimate needs and interests;
- How the organization tailors its business model and strategy to respond to its external environment and the risks and opportunities it faces;
- The organization's activities, performance (financial and other) and outcomes in terms of the capitals—past, present and future.

Thus, IR aims to move beyond a “silo” approach of information gathering and reporting, toward a more comprehensive assessment and presentation of a company's value creation drivers and performance. Thus, it presents a more holistic view of information that is relevant to the strategy, to the business model and to create and sustain value over time.

Therefore, we expect sustainable companies that embrace Integrated Thinking to increase shareholder value creation in the long term because they are better prepared to face economic, social and environmental risks. In other words, they will be around in the long run, because Integrated Thinking will help them mitigate risks and have a sustainable business model; that results from integrated decision-making and actions that consider the creation of value.

Capital providers recognizing that their investment risk is lower in these more sustainable companies should in turn reduce their risk premiums. Thus, IR leads to more sustainable companies that are less risky in the eyes of capital providers; the result is lower cost of capital.

The issue of sustainability and Integrated Thinking will be especially important for long-term investors, like pension funds and insurance firms. In this same line of thinking, Serafeim (2014) states that while sus-

tainability data could be relevant over any time frame, it is often argued that they are primarily informative about the long-term prospects of the business.

Contrarily, unsustainable business models that neglect the environment, society or the human capital will not be around in the future; but even if they do, they will face higher cost of funding derived by higher risks that will be taken into consideration by investors and creditors.

Cost of capital will also be reduced if investors have visibility over the management's understanding of key risks regarding a sustainable business model. The rationale is that IR will give the market a signal of a firm's intention and progress toward integration of environmental and social issues in its organization processes. This is because a central tenet of IR is placing the sustainability activities of a firm within the context of an organization's strategy and business model.

According to Serafeim (2014), many commentators have argued that because IR could be an effective mechanism to communicate a firm's capacity to create value in the long-term, firms that practice IR might find themselves looking more attractive to long-term investors.

In this sense, Integrated Thinking and IR should lead to lower cost of capital for companies that adopt them, because such companies are more likely to be around in the long run, will be more sustainable over time and will be able to mitigate externalities and create value, being therefore less risky in the eyes of investor.

As mentioned earlier in this chapter, IR is still in its infancy. Thus, we were not able to find any empirical work that analyzed the relationship between Integrated Thinking, brought by IR, and the cost of capital. However, there are a few recent studies on the relationship of sustainability and cost of capital. Table 13.2 below briefly presents some of these studies.

Final Remarks

The objective of this chapter was to theoretically address the relationship between IR and cost of capital. For these, we have examined the existing accounting, finance and sustainability literature as well as the main concepts in the IR Conceptual Framework.

Table 13.2 Prior studies on sustainability and cost of capital

Authors—journal	Description of the study
Ghoul et al. (2011)— <i>Journal of Banking and Finance</i>	Examined the effect of corporate social responsibility (CSR) on the cost of equity capital for a large sample of U.S. firms. The authors used several approaches to estimate firms' ex ante cost of equity. Their results show evidence that firms with better CSR scores exhibit cheaper equity financing
Wua et al. (2014)— <i>Emerging Markets Finance and Trade</i>	Investigated the relationship between CSR and the cost of capital. These authors used a sample of companies from the Taiwan stock market. Their results suggest that firms with CSR awards have lower cost of capital
Arxab and Zieglerac (2014)— <i>Quantitative Finance</i>	Analyzed the effect of CSR on corporate financial performance. Their sample is composed of different regions, namely the USA and Europe. The authors also disentangled firm and sector specific impacts. Their statistical analysis shows that environmental and social activities of a firm are valued by financial markets in both regions, in comparison to other firms within the industry
Xu et al. (2015)— <i>Australian Journal of Management</i>	Examined the effect of CSR towards primary stakeholders on the cost of equity capital in Chinese listed firms. The authors divided the sample into state-owned enterprises (SOEs) and non-state-owned enterprises (NSOEs) for comparison. Their results show that firms with higher CSR scores have significantly lower cost of equity capital

We've argued that there should be a negative relationship between IR and cost of capital, i.e. IR should lower the company's cost of debt and equity in the medium and long terms. In our view, these effects derive from two main factors: (i) the adoption of a sustainable business model due to integrated thinking and (ii) an information asymmetry reduction caused by greater transparency, allowing more informed forecasts that will guarantee positive returns for investors and creditors in the long run.

As discussed in this chapter, information asymmetry causes problems such as adverse selection and moral hazard, which increases the cost of capital. In this sense, greater transparency that comes with IR reduces the uncertainty around the decision making for capital providers. As a result, investors will be able to better understand the organization strategy, its business model and how the corporation creates value over time.

The accounting and finance literature has abundant evidence of the negative relationship between disclosure levels and cost of capital (see for instance: Botosan 1997; Sengupta 1998; and Hail 2002; Lopes and Alencar 2010; Dhaliwal et al. 2011).

Also, as discussed in the text, the concept of “Socially Responsible Investing (SRI)” has gained attention in recent years, especially due to the global warming and the financial crises. This has led to the creation of several sustainable Stock Indexes (Dow Jones Sustainability Indexes, the FTSE4Good Series, the Johannesburg Stock Exchange SRI Index and the BMF BOVESPA Sustainability Index “ISE”) and also attracted the attention of large investment funds such as BlackRock.

In our view, IR gives the market a signal of a firm’s intention and progress toward integration and Integrated Thinking, as it places the sustainability activities within the context of an organization’s strategy and business model.

In this sense, we expect that long-term investors, like pension funds and insurance companies, show privilege to companies with Integrated Thinking because they will be better prepared to face economic, social and environmental risks.

Recent literature that has studied the relationship between sustainability and the cost of capital has showed that sustainable companies tend to be better valued by the financial markets. (see for instance: Ghoul et al. 2011; Wua et al. 2014; Arxab and Zieglerac 2014; Xu et al. 2015).

Finally, it is worth mentioning that the relationship between IR and cost of capital is after all an empirical question. Future empirical work is needed to demonstrate the expected negative relationship between IR and cost of capital.

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14

Assurance and Other Credibility Enhancing Mechanisms for Integrated Reporting

Roger Simnett, Shan Zhou, and Hien Hoang

Abstract The information reported in accordance with the Integrated Reporting Framework of the International Integrated Reporting Council (IIRC) will not be useful for its intended purpose unless it is both credible and perceived to be credible. The Framework outlines the importance of independent external assurance, but also identifies other credibility-enhancing mechanisms, including robust internal control and reporting systems, stakeholder engagement, and internal audit. In 2014 and 2015, the IIRC engaged in a further international stakeholder consultation process seeking to gain feedback on these issues. Using an examination of the responses to the consultation processes and a review of current practices,

R. Simnett (✉)

Centre of Social Impact and School of Accounting, UNSW
Business School, Kensington, Australia

S. Zhou

Discipline of Accounting, University of Sydney, Sydney, Australia

H. Hoang

School of Accounting, UNSW Business School, Kensington, Australia

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this chapter outlines the journey to the current credibility-enhancing suggestions. It also identifies current innovative processes for increasing the credibility of the information contained in integrated reports, and associated future research opportunities.

Introduction

It is important that mechanisms are implemented to ensure that reliance can be placed on integrated reports. Without such suitable credibility-enhancing mechanisms, there is the potential for these reports to be, and be perceived to be, nothing more than marketing documents, or green-wash, and therefore they will not achieve their full potential in providing the report user with a broader range of relevant and reliable information for decision-making. This has been recognized by the IIRC, which has engaged in a series of public consultation processes which have included the topic of assurance for integrated reports (IIRC 2014a, 2014b).

The IR Framework (IIRC 2013b) identifies a number of mechanisms to enhance the reliability of an integrated report, including robust internal control and reporting systems, stakeholder engagement, internal audit or similar functions, and independent, external assurance. The one that is commonly referred to in the consultation processes and is outlined by the IIRC as important to IR as a key mechanism to help ensure that integrated reports are, and are seen to be, credible, is independent external assurance. A significant majority of respondents to the Consultation Draft of the Framework (IIRC 2013a) agree that there is a need for external assurance of an integrated report and that independent, external assurance is a fundamental mechanism for ensuring reliability and enhancing credibility.

There are practical challenges to assuring integrated reports, such as whether traditional assurance models will be an appropriate fit for IR. In addition, the broader subject matter means an increased complexity in the assurance skill set required, most likely requiring multidisciplinary assurance teams. These challenges raise the issue as to whether the cost of assurance on an integrated report will be disproportionate to the perceived benefits. It is primarily for this reason that the IIRC does not require,

but only encourages, independent assurance on integrated reports in the IR Framework. There are also a number of technical challenges outstanding in the assurance of integrated reports, such as identifying materiality levels, the level of assurance that can reasonably be provided on aspects of the integrated report, and how to assure more discursive and future-oriented information (IIRC 2014b). The IIRC has therefore undertaken a recent international stakeholder consultation process seeking to gain input to these issues (IIRC 2014a, 2014b).

This chapter outlines the assurance considerations of the IIRC 2013 and 2014 consultation processes. It then evaluates the approach of the International Auditing and Assurance Standards Board (IAASB) with regard to Integrated Reporting (IR), and considers the alternative credibility enhancing mechanisms that are evolving in practice. An identification of research opportunities is undertaken, with the last section providing concluding remarks.

The Consideration of IR Assurance in the 2013 IIRC Consultation Draft Process

In April 2013 the IIRC released a draft prototype of the Framework, the Consultation Draft, and invited comments on all parts of the Framework. The Consultation Draft received 352 responses in total from various stakeholders: report preparers, investors and analysts, regulators, accountants and auditors, professional service bodies, and other stakeholders. Of the 352 respondents, 259 answered the question as to whether assurance should be obtained on the whole of the integrated report or only on specific components of the report. The responses to this question, broken down by type of respondent, are summarized in Table 14.1.

The analysis of the responses shows that the majority of respondents agree with the need to assure integrated reports (only 6.2 % of respondents disagree that assurance is needed to be obtained on the integrated report, primarily because it was too early in the IR journey). However, when it comes to whether assurance should be on the whole integrated report, or on specific components of the report, the preference is less clear.

Table 14.1 Responses to question 19 in the IIRC consultation draft process 2013: assurance on the whole report versus specific components

Question 19	Providers of						Total
	Report preparers	financial capital/analysts	Regulators	Accounting/assurance	Consultants	Others	
Fully agree that the whole report should be assured	28 (35.4 %)	5 (14.7 %)	4 (30.8 %)	15 (30.0 %)	9 (30.0 %)	17 (32.1 %)	78 (30.1 %)
Agree with minor qualification that whole report should be assured	21 (26.6 %)	18 (52.9 %)	4 (30.8 %)	16 (32.0 %)	4 (13.3 %)	12 (22.6 %)	75 (29.0 %)
Agree that specific aspects should be assured	18 (22.8 %)	7 (20.6 %)	1 (7.7 %)	7 (14.0 %)	11 (36.7 %)	11 (20.8 %)	55 (21.2 %)
Disagree: assurance should not be obtained	3 (3.8 %)	3 (8.8 %)	1 (7.7 %)	2 (4.0 %)	0 (0.0 %)	7 (13.2 %)	16 (6.2 %)
Unsure opinion	9 (11.4 %)	1 (2.9 %)	3 (23.1 %)	10 (20.0 %)	6 (20.0 %)	6 (11.3 %)	35 (13.5 %)
Total number of respondents to Q19	79 (100 %)	34 (100 %)	13 (100 %)	50 (100 %)	30 (100 %)	53 (100 %)	259 (100 %)

Source: Hoang and Simnett (2013).

The majority of the stakeholders prefer independent assurance on the whole integrated report (59.1 % agree or agree with minor qualification), primarily because whole-report assurance is believed to enhance the credibility of information to a greater extent and concepts such as materiality and connectivity require the whole report to be considered. Whole-report assurance is also supported by Eccles et al. (2012) who suggest that the value of the integrated report can only be maximized when accompanied by integrated assurance, and Ridehalgh (2010), who contends that “one report” should have “one audit”. However, the support for specific-component assurance (21.2 %) is still substantial, primarily for the reason that the feasibility of assuring the whole report is currently questionable due to the lack of appropriate assurance standards, skills and systems to support such a novel approach of assurance. The levels of support were found to be fairly evenly distributed across the different types of respondents.

While there is considerable support for the need to enhance the credibility of the integrated reports, an agreed view emerged that the costs of assurance should not be imposed on organizations at this early stage of the IR journey, when exactly what an integrated report looks like in practice may differ from organization to organization. It was also recognized that external assurance is not necessarily the only way to increase the credibility and usefulness of the information contained in the integrated report, with internal audit, management signoffs and description of robust reporting processes suggested as alternative mechanisms to enhance the report users' confidence in the information. In response to this consultation, the IR Framework, which was released later in December 2013, does not require the integrated report to be externally assured, but acknowledges that the reliability of reported information can be enhanced by mechanisms such as external assurance, robust internal control and reporting systems, stakeholder engagement, internal audit and responsibility statements by those charged with governance.

The 2014 IIRC Assurance Consultation Process

In order to follow up further on the assurance issues outstanding after the approval of the Framework in December 2013, in July 2014 the IIRC released two discussion papers. These are an introductory paper entitled

“Assurance on IR: An Introduction to the Discussion” (IIRC 2014a), which was released together with a more detailed paper “Assurance on <IR>: An Exploration of Issues” (IIRC 2014b). These discussion papers clarify that the IIRC is not, and does not aspire to become, a key player in the assurance field. However, the IIRC does seek to promote robust assurance, along with other mechanisms that build the credibility of, and trust in, IR. Assurance was seen to play a vitally important role in ensuring that integrated reports and the IR process are, and are seen to be, credible.

The purpose of these discussion papers is to help stakeholders understand the role of assurance and to initiate a global discussion on the benefits and challenges it presents. A number of assurance challenges are identified in these discussion papers including practical implementation challenges and technical challenges. Practical implementation challenges identified include:

1. *The nature of assurance.* Will a single pathway to assurance suit all reporters, or should mechanisms such as internal systems and stakeholder involvement be substitutes for, rather than preconditions or adjuncts to, assurance?
2. *Appropriate underlying subject matter for IR assurance.* Should IR assurance engagements be on the process to prepare the integrated report or on the underlying data processes of the integrated report, or both?
3. *The development of assurance methodologies.* Is the application guidance founded on the fundamentals of existing assurance standards appropriate, or is a new approach to assurance needed to match IR’s new approach to reporting?
4. *Assurance practitioners.* Will the availability of suitably skilled and experienced assurance practitioners be a problem in some jurisdictions?
5. *Internal systems.* Are reporters’ internal systems robust enough for assurance?
6. *The cost of assurance.* Do the benefits of assurance outweigh the additional costs over the short, medium and long term?

The IIRC discussion papers also identified a number of technical challenges primarily aimed at informing the work of assurance standard setters. These technical challenges include:

1. *The existence of suitable criteria.* Does the International IR Framework (the Framework) constitute suitable criteria?
2. *The development of assurance standards.* Should assurance standard setters develop a new separate assurance standard and/or guidance for assurance engagements on integrated reports?
3. *Methodological and related issues,* including the assurability of future-oriented information, soft narrative and the completeness of a report; and dealing with materiality, the reporting boundary and connectivity for assurance purposes. What is the level of assurance that is appropriate and should the assurance report be “short form” or include more informative commentary?

Feedback from IIRC 2014 Assurance Consultation Process

The IIRC discussion papers were debated in a number of forums contributed to by around 400 people around the world during the second half of 2014 and 63 written submissions were received during the consultation period (IIRC 2015). The IIRC released a response document in 2015 entitled “Assurance on <IR>: Overview of feedback and call to action” (IIRC 2015), which summarizes significant matters raised in the debate on the discussion papers. As shown in Table 14.2, which summarizes the responses to the question “What priority should be placed on assurance?”, the majority (84.1 %) of the 44 respondents to this question agree that assurance should be given high priority, or that it should be a priority depending on the reporting stages, reporting entities’ needs and the importance of other credibility-enhancing mechanisms.

The IIRC response document expresses the view that the IR assurance journey cannot be taken by one traveler alone. Other groups critical in ensuring that the journey is fruitful include those charged with governance and senior management, internal audit, assurance standard setters and assurance practitioners. A summary of the views of the respondents to the practical implementation challenges identified in the discussion papers are:

Table 14.2 Responses to question 1 in the IIRC 2014 consultation process: what priority should be placed on assurance in the context of driving credibility and trust in IR?

Answer to Question 1	Providers						Total
	Report preparers	of financial capital and analysts	Regulators	Accounting/ assurance and professional bodies	Consultants	Others	
Fully agree that assurance should be a high priority	1 (25.0 %)	0	0	13 (53.8 %)	1 (14.3 %)	2 (50.0 %)	17 (38.6 %)
Agree that assurance should be a priority, but there is a long journey	1 (25.0 %)	0	1 (33.3 %)	4 (15.4 %)	2 (28.6 %)	1 (25.0 %)	9 (20.4 %)
Agree that assurance should be a priority, but other mechanisms are also important	1 (25.0 %)	0	1 (33.3 %)	1 (3.85 %)	1 (14.3 %)	1 (25.0 %)	5 (11.4 %)
Agree that assurance should be a priority, but it depends on the users' needs	1 (25.0 %)	0	0 (0.0 %)	4 (15.4 %)	0 (0.0 %)	0 (0.0 %)	5 (11.4 %)
Agree that assurance should be a priority, but it depends on the type of disclosures	0 (0.0 %)	0	0 (0.0 %)	0 (0.0 %)	1 (14.3 %)	0 (0.0 %)	1 (2.3 %)
Disagree: assurance should not be a priority	0 (0.0 %)	0	1 (33.3 %)	3 (11.5 %)	2 (28.6 %)	0 (0.0 %)	6 (13.6 %)
Disagree: Assurance is not relevant	0 (0.0 %)	0	0 (0.0 %)	1 (3.8 %)	0 (0.0 %)	0 (0.0 %)	1 (2.3 %)
Total number of respondents to Q1	4 (100 %)	0	3 (100 %)	26 (100 %)	7 (100 %)	4 (100 %)	44 (100 %)

Source: Hoang and Simnett (2013)

1. *The nature of assurance.* A view commonly expressed by respondents is that assurance is only one of many mechanisms that organizations can use to enhance credibility and trust in IR. Other mechanisms include involvement of external stakeholders, robust risk management models, a strengthened role for internal auditors, and public disclosures by those charged with governance. Respondents also generally acknowledge that assurance on IR will need to evolve alongside the practice of reporting itself.
2. *Appropriate underlying subject matter for IR assurance.* There was no clear consensus among respondents about the appropriate scope for assurance. Suggestions made include assuring the processes underlying IR, assuring all or some of the information in the integrated reports, or assuring the integrated report as a whole.
3. *The development of assurance methodologies.* Many respondents express the need for innovation in the development of assurance methodologies for IR. Others, however, caution against prematurely rejecting existing principles and methodologies and argue that current assurance standards and frameworks can potentially accommodate assurance on IR, at least for an interim period.
4. *Assurance practitioners.* Many respondents note that assurance on IR calls for a range of skills and expertise from assurance practitioners, including a comprehensive understanding of how value is created across the full range of capitals and an appreciation of “systems thinking”. Many respondents also note that this broad range of skills can potentially be accommodated by current assurance practices through the use of multidisciplinary teams or bringing in outside subject matter specialists.
5. *Internal systems.* Many respondents note that the internal systems needed for IR are far less mature than systems for “financial” reporting. Some suggest that early and ongoing involvement of external assurance practitioners can assist preparers in developing internal systems and that there is a need for flexibility in the expectation that assurance solutions will evolve as practice in this area matures.
6. *The cost of assurance.* The general theme from respondents is that it is difficult to articulate and assess the total costs and benefits of assurance on an integrated report with precision. However, it is likely that assurance will become more cost effective as more experience in this area is accumulated.

The technical challenges identified in the IIRC discussion papers are primarily aimed at informing the work of assurance standard setters. The IIRC acknowledges that the IAASB has set up an Integrated Reporting Working Group (IRWG) and is reviewing responses to the technical challenges raised by the IIRC. Therefore, the summary of feedback on technical challenges in the IIRC document has been kept brief as follows:

1. *The existence of suitable criteria.* There was divergence in views on the suitability of the IR Framework as criteria for assurance. This matter was considered when the Framework was being developed, with the consequential inclusion in the Framework of a requirement to disclose a summary of the significant frameworks and methods used to quantify or evaluate material matters. This issue will be considered again when the Framework is next revised.
2. *The development of assurance standards.* Mixed views were expressed about whether a new standard(s) should be developed for IR assurance or whether extant assurance standards are sufficient. There are also mixed views about whether any standards or guidance should be specific to IR or should generally cover topics that are also relevant to other forms of reporting and assurance, for example, narrative information.
3. *Methodological and related issues.* Respondents provided detailed and varied feedback on issues including materiality, the reporting boundary, connectivity, completeness, narrative reporting and future-oriented information, and levels of assurance.
4. *Other topics.* In addition to the first three issues, respondents identified a number of other topics for consideration, including the role of “combined assurance”—a new corporate governance practice recommended by the King III report on integrating different credibility-enhancing mechanisms, the relevance of jurisdiction or industry-specific issues, and the role of stakeholder engagement.

IAASB Working Group

The IAASB is identified by the IIRC as one of the key groups contributing to the IR assurance journey. The IAASB sets international auditing and assurance standards in the public interest, including standards that

could be applied to assurance on IR. The IAASB has recently established the IRWG to: “(i) monitor and inform the IAASB about emerging developments in external reporting; (ii) research on the demand for assurance, the scope of the assurance engagement and the key assurance issues; and (iii) explore how the IAASB most effectively can respond via International Standards or non-authoritative guidance (including Staff publications) and in what timeframe” (IAASB 2014).

In July 2015, the IAASB issued a working group publication entitled “Exploring Assurance on Integrated Reporting and Other Emerging Developments in External Reporting” (IAASB 2015). The purpose of the publication is to inform stakeholders of the ongoing work taken by the IAASB to explore assurance on IR and other emerging developments in external reporting, as well as to outline the activities of the IRWG. The IAASB acknowledges the work performed by the IIRC in exploring assurance issues related to IR and states that it is continuing to work with the IIRC and other stakeholders to fully understand the assurance issues raised. The IRWG is already exploring a number of issues that are highlighted by the IIRC’s discussion papers and feedback, including the nature of assurance, the suitability of the Framework as criteria for assurance, and the necessary competence and capability of assurance practitioners (IAASB 2014c).

The IAASB intends to issue a discussion paper to seek additional feedback on these issues. The information gathered will assist the IAASB to consider how and when to respond to these developments most effectively in the public interest, including whether new or revised International Standards or guidance to support the application of existing standards may be necessary.

Alternative Credibility-Enhancing Mechanisms for the Integrated Report

As outlined earlier, the credibility of integrated reports can be enhanced through a number of mechanisms. The traditional major credibility-enhancement mechanism is external assurance, which is well-developed in the financial statement setting, and has been adapted and applied to environmental, social and governance disclosures. The common conceptual

framework underpinning financial statement auditing, a framework also relevant for non-financial reporting, is agency theory, where managers (report preparers) prepare financial statements (integrated reports) to provide information to their shareholders (report users) on the resources (including non-financial) entrusted to managers. The financial statements (integrated reports) are assured by auditors to provide confidence that managers do not abuse this trust or use these resources for other than the benefit of the capital providers, and that the reported information can be relied on by report users to make their decisions.

There are other mechanisms that can enhance the credibility of integrated reports, a number of which are mentioned in the IR Framework in the discussion of the reliability of the report (IIRC 2013b, para 3.40). These mechanisms involve enhanced communications to report users from various parties, such as the following four categories:

1. *Corporate governance processes* of the reporting entity plays an important role in assuring the entity against major risks, including reporting risks. Strong corporate governance enhances the quality of reporting processes which results in more reliable and relevant reported information. A description of these corporate governance processes can increase the report users' reliance on the information contained in the integrated report.
2. *Statements and signoffs by those who have a responsibility for the report* demonstrates that the directors explicitly take the responsibility for ensuring the integrity and reliability of the integrated reports, which improves its credibility in the eyes of report users.
3. *Internal audit* provides assurance on the effectiveness of the internal controls and processes that are relied on to produce the report. The internal auditor's conclusion that the internal controls of financial and non-financial reporting are effective will improve the credibility of the information in the integrated report. Internal audit can also enhance consistency of measurement and communication of metrics across business units, as well as provide assurance to increase the credibility of metrics and offer insight on potential risks to the organization (IIA 2013).

4. *Independent opinion on the effectiveness of IR processes expressed by assurance providers (either external or internal)*. Because of the importance of internal reporting processes, assurance of the internal control systems from which the reports have been generated can be beneficial in promoting transparency and enhancing report users' confidence in the information.

These credibility-enhancing mechanisms may substitute or complement each other. There are certain limitations of seeing these mechanisms as operating independently when the reporting and other governance processes have been integrated in accordance with the IR principles. The integrated nature of the reporting processes and the many broad types of reported information calls for innovative forms of credibility enhancement that can accommodate the connectivity between the different components of the integrated reports.

One innovative integrated credibility-enhancing mechanism is the emerging corporate governance practice recommended by the King III Report (Principle 3.5), namely "combined assurance". This is a model of "integrating and aligning assurance processes" with the aim of improving the assurance quality through better coordination of assurance providers. Combined assurance recognizes that there are three "lines of defense" that manage the risks and improve reporting quality: (1) management, (2) internal assurance providers, and (3) external assurance providers.. The activities of these assurance providers need to be coordinated under a combined framework in order to avoid silos, maximize the assurance coverage, and address significant risks of the business. The King III Report assigns the responsibility of developing and overseeing the combined assurance framework to the audit committee.

From its definition, combined assurance can be seen as both a risk management and an assurance practice. This suggests that there are two ways through which combined assurance enhances the credibility and usefulness of the integrated reports: (i) by enhancing risk management and overall governance of the firm, thus leading to higher reporting

quality, and (ii) by enhancing the coordination of assurance providers' activities, thus leading to higher assurance quality.¹

Research Opportunities

Current issues in enhancing the credibility of integrated reports call for future research to inform the debate and challenges in determining the demand and benefits of independent assurance and other enhancing mechanisms, setting assurance standards for integrated reports and constructing assurance engagements in practice. There are ample research opportunities in relation to the credibility enhancement of integrated reports (Adams 2014; Cheng et al. 2014; de Villiers et al. 2014; Simnett and Huggins 2015). The emerging research themes are summarized in the following subsections, 7.1 and 7.2.

Drivers and Benefits of Independent Assurance and Other Credibility-Enhancing Mechanisms

It is necessary to understand what drives the reporting entities' decision to obtain independent assurance and implement other credibility-enhancing mechanisms. As evident in the South African market, not every entity chooses to assure the non-financial components of their annual reports or implement a combined assurance model, even though it is recommended by the King III Report. It is therefore beneficial to conduct empirical and qualitative studies to investigate the factors that influence the companies' decision to implement a credibility-enhancing mechanism or a combination of mechanisms, and why they choose certain mechanisms over the others.

Another important research issue is whether the credibility-enhancing mechanisms bring benefits to the reporting entity. Both behavioral and archival research methods can examine the reaction of report users to the independent assurance of non-financial components, the combined

¹ An example of what the combined assurance report looks like can be found here http://datatec.investoreports.com/datatec_ar_2011/integrated-report/combined-assurance/ (Datatec 2011).

assurance model and other alternative mechanisms at the capital market level and individual level. For instance, do the mechanisms make a difference to the decision making of report users, by changing their estimates of firm's value and their consequential willingness to invest, resulting in a lower cost of capital for the reporting entity, or improvement in analysts' forecasts?

Informing the Development of Assurance Standards and Guidance and Constructing Assurance Engagements

Issues revolve around whether the existing auditing standards (ISA series) and assurance standards (IAASB 2013) provide sufficient guidance, or whether it is necessary to develop a separate set of standards to accommodate the unique elements of IR, including connectivity, conciseness, forward-looking statements and other strategic and discursive information. To inform this standard setting debate, research on the costs and benefits of providing different credibility-enhancing approaches is beneficial. This includes a consideration of how best to utilize current audit and assurance approaches (such as the financial statement audit) as well as assurance on sustainability reports, and other mechanisms whose public disclosure can enhance credibility. Future research can explore and contribute to resolving the challenges in assuring integrated reports, such as assuring forward-looking and discursive statements as well as the concepts of materiality, connectivity and conciseness under IR. Research can also contribute to better understanding the conduct of multi-disciplinary assurance teams and optimizing their performance.

Discussion and Conclusion

This chapter has outlined the demand for, and the importance of suitable credibility enhancing mechanisms on an integrated report. Without such mechanisms, there is the potential for integrated reports to not achieve their full potential in providing relevant and reliable information. A

review of the two consultation processes undertaken by the IIRC identify a range of different views, but generally recognize that independent external assurance will play an important role in enhancing credibility. There are however a number of technical and practical implementation challenges to ensuring that it is cost beneficial given the broader range of information and concepts required to reporting accordance with the Framework. These consultation processes and a review of current practices reveal that there are other assurance enhancing mechanisms which alone or in combination are evolving, including the disclosure of corporate governance processes, internal audit, assurance on the effectiveness of the reporting processes, and signoff by those who are responsible for the report. The public reporting of the mechanisms by which those responsible for the report have gained their confidence that the information in the report is relevant and reliable and meets the requirements of the Framework, will be beneficial to enhancing the confidence of the report users. In particular, innovative approaches to combined assurance are observed in South Africa and continue to evolve. Finally, this chapter outlines research opportunities that can promote evidence based discussions, including the drivers and benefits of independent assurance and other credibility-enhancing mechanisms and informing the assurance standard setting process.

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15

IR: The Big Promise and the Expectation Gap

Chiara Mio and Marco Fasan

Abstract This chapter will discuss the expectation gaps generated by Integrated Reporting (IR) and, more broadly, the motivations that pushed companies towards IR, the difficulties in its implementation process, and finally its possible benefits. Empirical evidence was gathered through questionnaires distributed to Italian companies and investors. The results of our analysis suggest that companies generally reported some kind of benefit deriving from IR implementation; conversely, investors are not fully satisfied with the way Italian companies are implementing IR. The divergent views between companies and investors suggest that IR has already provided companies with some “internal” benefits, in terms of better internal strategy communication and improvement in integrated thinking. Nevertheless, “external” benefits, in terms of external disclosure, are yet to be achieved, thus generating an investor expectation gap.

C. Mio (✉) • M. Fasan

Department of Management, Ca' Foscari University of Venice, Venice, Italy

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Introduction

Integrated Reporting (IR) emerged mainly as a response to the shortcomings of traditional financial and sustainability reporting. Such reporting tools are not able to provide the information investors need in order to make informed decisions, given that, in the current business environment, company disclosure needs (among other factors) to focus on non-financial information, its connection to financial performance and, most importantly, it needs to be concise (see Plumee 2003; Li 2008; Miller 2010).

IR aims to meet these challenges by providing information on the company's strategy, corporate governance, performance and prospects in such a way that reflects the commercial, social, and environmental context in which it operates in a composite, organized and cohesive form (see Frias-Aceituno et al. 2012).

Given the ambition of such promises, IR may have caused some expectation gaps among IR preparers and users, in such a way that the expectations of one or more may have been disappointed (see Flower 2015). This chapter aims at gathering information on such gaps in expectations and, more broadly, at discussing the motivations that pushed companies towards IR, the difficulties in the IR implementation process and, finally, the potential effects (benefits) of IR. It also focuses on investors, which are arguably the most important audience for IR, and specifically on their opinions of IR's potential impact on the evolution of corporate disclosure and their judgement of the current quality of IR implementation. In order to accomplish this task, we collected empirical evidence through questionnaires distributed to Italian companies and investors. Focusing only on one country allows making unbiased comparisons among companies and investors.

The analysis allowed us to gather significant insights, which may be useful to companies, investors, policy makers and academics. In particular, our results show that companies had significant expectations that IR would improve their internal strategy communication and integrated thinking. This suggests that companies consider IR to be a holistic disclosure tool, potentially providing benefits not only in terms of external disclosure but also internally. Conversely, current academic literature (see Abeysekera (2013), Frias-Aceituno et al. (2012), Adams and Simnett

(2011), Adams (2015), de Villiers et al. (2014), Flower (2015), Stubbs and Higgins (2014) and Lozano (2013)) mainly draws upon analyses of reports and formal documents rather than engaging directly with firms, thus neglecting the internal dimension of IR implementation. Instead, scholars should focus on the effect IR has on internal reporting and organizational change, thus providing a new perspective to IR research.

The results of our analysis also show that the main expectation gap has been experienced by investors, while companies generally reported various benefits deriving from IR implementation. On the one hand, investors have confidence that IR is the future of corporate reporting and that it is a very useful tool in order to assess a company's ability to create value in the short, medium and long term. On the other hand, they are not fully satisfied with the way in which Italian companies are implementing IR, as they believe that performance disclosure is still unbalanced and that the connectivity principle has not been properly applied. In other words, investors see a significant gap between theory (the IIRC Framework) and practice (IR implementation).

The divergent views between companies and investors suggest that IR has already provided companies with some "internal" benefits, in terms of better internal strategy communication and improvement in integrated thinking. Nevertheless, "external" benefits, in terms of external disclosure, are yet to be achieved, thus generating an expectation gap for investors. We argue, building on our empirical evidence, that the main challenge is finding adequate Key Performance Indicators (KPIs) to measure stock and flow of capital. Finally, we propose some possible avenues through which to overcome such measurement issues.

Methodology

In order to gather empirical evidence about our research questions, we distributed a questionnaire to Italian companies and investors. We focused on these two categories because of the nature of the IIRC Framework, which provides indications mainly to companies on how to build their IR and, at the same time, has a strong orientation towards investors. We chose to focus only on one country (Italy) in order to disentangle

issues related to country-level effect. Previous studies (see, among others, La Porta et al. 1999) found that different countries have different characteristics in a number of dimensions. In particular, we selected Italian companies that either (i) joined the IIRC Pilot Program and published an IR or (ii) published an IR according to the IIRC Framework. Following these criteria, we selected six companies and five institutional investors.

The questionnaire includes 22 close-ended questions for companies and 15 close-ended questions for investors. It generally provided five different answers to each of the questions, and interviewees were required to indicate their level of agreement or disagreement for each answer on a five-point scale (where 5 is strong agreement, 4 is agreement, 3 is neutral, 2 is disagreement and 1 is strong disagreement). In the graphs, for each question, the bars represent, from the left to the right, respectively: strong agreement, agreement, neutral, disagreement, strong disagreement. We also allowed interviewees to provide their own answer to each question, in case they felt that the options provided were not exhaustive.

The aim of the questionnaire delivered to companies was to gather information about three different issues: (i) the motivations and expectations that led companies to implement IR; (ii) the IR implementation process; (iii) the possible effects (benefits) of IR. When interviewing the investors, we mostly aimed at understanding their opinion about the potential impacts of IR on the evolution of corporate disclosure, and their judgement on the current quality of IR implementation.

Companies

Motivations and Expectations Towards IR

The first issue we investigated concerns the motivations that led companies to issue an IR. The answers received from the companies pointed to two main motivations. The first is the existence of external pressures from society (“companies must implement an IR due to pressures from society”). This motivation is consistent with institutional theory, which posits “once a practice is institutionalized, it is seen as necessary by managers and becomes implemented, not for rational reasons or to achieve

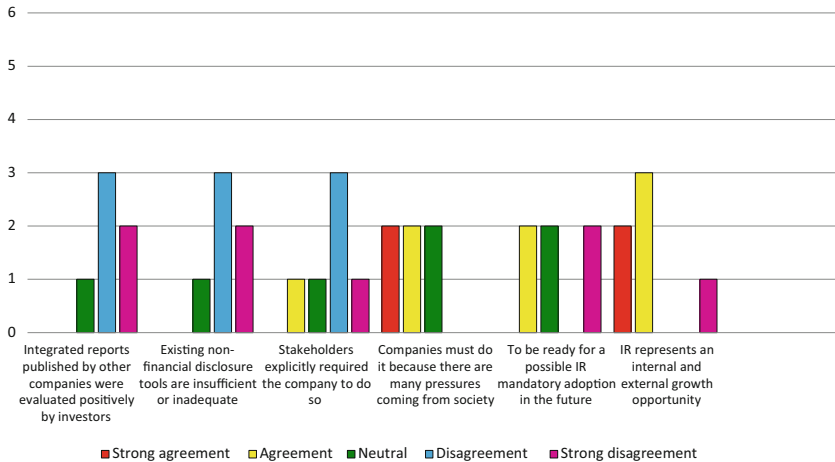


Fig. 15.1 Why did you decide to produce an Integrated Report?

Source: our elaboration on our database.

specific strategic outcomes (e.g. stakeholder support or reputation), but in order to fit in with social expectations” (see Higgins et al. 2014). The second motivation is “internal”, and more specifically connected to the possibility of achieving growth (Fig. 15.1).

While these two motivations (internal and external) played a central role in the companies’ decision to implement IR, the existence of positive impacts for companies that had already implemented IR does not. This is reasonable, as IR is still too young to have a significant track record. Interestingly, none of the respondents indicated that “the existing non-financial information disclosure tools are insufficient or inadequate”. Taken together, these indicators suggest that companies see IR as an additional disclosure tool that does not replace existing corporate disclosure, but rather acts as a complement, consistent with the IIRC Framework approach (Fig. 15.2).

Although companies believed that existing non-financial disclosure tools were adequate, IR created significant expectations, reinforcing the idea that IR is seen as being different to existing disclosure tools. None of the companies agreed that IR would have had no significant effects. Instead the most agreed-upon expectations were: (i) increased investor

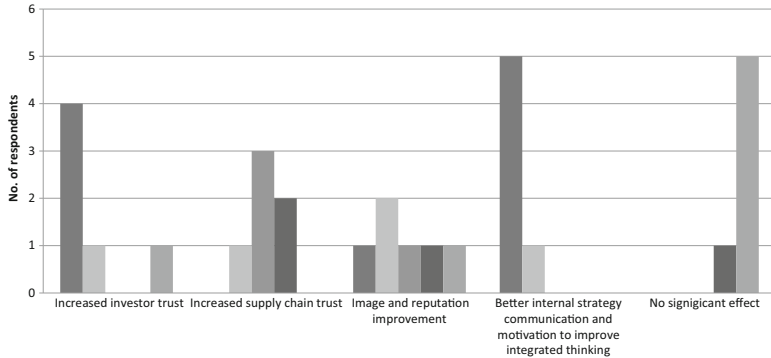


Fig. 15.2 What did you expect from the publication of an IR?

Source: our elaboration on our database.

confidence in company disclosure and (ii) better internal strategy communication and motivation to improve integrated thinking.

The first expectation is fully in line with the IIRC Framework, which lists the following as the first objective of IR: “improve the quality of information available to providers of financial capital to enable a more efficient and productive allocation of capital” (IIRC 2013a, p. 2). Regarding the second expectation, it is interesting to note that, while academic literature on IR has mostly focused on the external dimension of IR, companies had significant expectations about the internal benefits of IR, in terms of strategy communication and improvement in integrated thinking.

The IR Implementation Process

According to our empirical evidence, the IR implementation process (ranging from the first meeting to the final publication of the report) generally took more than a year to be completed, and most of the companies did make use, to some extent, of external advisors during this process. Four out of six companies hired external advisors, but only for relevant matters; one company employed external advisors for a review at the end of the process; and only one company did not hire any external advisors (Fig. 15.3).

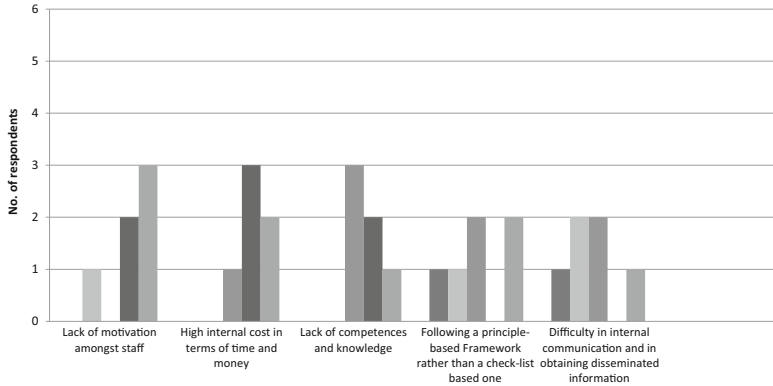


Fig. 15.3 What has been the main difficulty in producing the IR?

Source: our elaboration on our database.

Anecdotal evidence suggests that the path towards IR implementation was often quite challenging. We proposed five possible issues leading to difficulties in producing an IR. Our results show that the main challenge faced by companies was related to the lack of specific competences and knowledge and to the difficulties in following a principle-based framework. Also, the process of obtaining disseminated information was problematic. This last piece of evidence suggests that companies are probably still employing a silo thinking approach that makes it difficult to gather information belonging to different silos. In this perspective, IR is arguably an important tool for internal growth and internal communication improvement.

We then focused, with particular reference to the IIRC Framework, on the Guiding Principles (strategic focus and future orientation, connectivity of information, stakeholder relationships, materiality, conciseness, reliability and completeness, consistency and comparability), asking companies which was the most difficult principle to apply. Connectivity was by far the most challenging IR principle to implement. Anecdotal evidence confirms this result, as connectivity is arguably one of the most innovative IR principles, which really requires companies to identify (and measure) interconnections between different capitals, different performances, and different time frames. Moreover, Connectivity of Information is tightly linked to Materiality, which is also one of the IIRC's most innovative

principles, compared to previous standard corporate disclosure. Conversely, companies felt that stakeholder relationships, reliability and consistency were relatively easy to implement, probably because they had already experienced the implementation of these in sustainability reporting.

We dig deeper into the issue of the difficulties faced by organizations by proposing five different reasons for why principles were difficult to apply. We propose the following: “the principle is not clear”; “it was difficult to obtain information”; “there was disagreement with the principle”; “there was a lack of competences and knowledge”; “there was a lack of KPIs”. Our empirical evidence suggests that the lack of KPIs and the difficulty in obtaining information are the most agreed-upon explanations. Conversely, none of the companies pointed to any disagreement with the principle content.

In other words, companies agree with the aim of the principle, but at the same time they believe that it is difficult to implement, mainly due to the lack of specific KPIs to measure stock and flow of capitals. We included an additional question about KPIs. Empirical evidence shows that most of the companies relied on GRI G4 in order to define their KPIs, but at the same time believe that the lack of predetermined KPIs is the main reason for the difficulties in implementing IIRC principles. This suggests that the KPIs proposed by GRI are not adequate for the purposes of IR. Even though the IIRC has already made some efforts in suggesting some KPIs (see IIRC 2013b), it may consider issuing further guidance on the issue.

IR Adoption Consequences

One of the key purposes of the present work is to understand whether IR has actually led to any significant effect since its implementation. We hypothesized five answers: “increased investor confidence”, “increased supply chain confidence”, “image improvement”, “better internal strategy communication and motivation to improve integrated thinking”, and “no significant effect”. The vast majority of companies (four out of five) reported that there were significant effects following the implementation of IR. Specifically, these benefits are mainly connected to an improvement in company image, better internal strategy communication, and motivation to improve integrated thinking (Fig. 15.4).

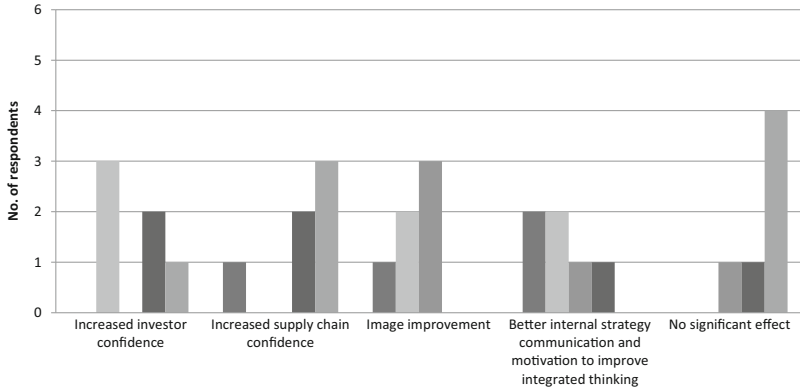


Fig. 15.4 What have you observed since the publication of an IR?

Source: our elaboration on our database.

If we compare these two results to the motivations that led to IR implementation (external pressures from society and internal/external growth opportunities), we can conclude that these have been (at least partially) met. The benefits in terms of investor confidence, conversely, are not clear, because half of the companies believed they gained some benefits, and the other half did not.

Companies also believe that the lack of knowledge about IR and the general skepticism towards ESG issues are the main obstacles to IR implementation in Italy. In order to make IR more widespread, companies believe that policy makers ought to increase IR knowledge in companies and create better assurance standards. Interestingly, making IR mandatory for all companies is not considered to be a solution for increasing IR adoption in Italy.

Investors

Since one of the primary audiences for IR is investors, we focused on this category, creating a specific questionnaire with questions primarily aimed at understanding investors' opinions on IR's potential impacts on the evolution of corporate disclosure, and their impressions on the current quality of IR implementation.

Investors generally agree that IR is a very useful tool in order to assess a company's ability to create value in the short, medium and long term. All the investors in our sample also believe that IR represents the future of external disclosure and that all Italian companies would enjoy significant benefits from its implementation. This result is very important, as it shows that investors support IR, and are confident about the benefits coming from its implementation.

At the same time, however, investors believe that Italian companies have not yet implemented their IRs in a way that can lead to all the potential benefits. In particular, investors believe that the performance disclosure is still unbalanced (none of the investors agree with the statement "companies describe appropriately both favorable and unfavorable results, business risks and unreached objectives"). It seems, in other words, that investors perceive that companies disclose mostly positive performance, while one of the main ideas underlying IR was to avoid the greenwashing effect that was generally considered one of the main shortcomings of sustainability reporting.

Investors also have some concerns about the way companies apply the connectivity principle. None of the investors, in fact, agree with the statement: "indicators used by companies to connect quantitative information with qualitative information are sufficiently adequate".

According to the investors, the adoption of IR by Italian companies has been slow, with the main reasons for this connected to cultural factors and to the lack of regulation. Policy makers should, in order to push more companies towards IR, increase IR knowledge and implement better assurance standards.

Discussion and Conclusion

Our analysis focuses on Italian companies and investors, and it allows us to draw several interesting conclusions about their expectations and judgements of IR.

One of the main results of the present analysis concerns the motivations that led companies to implement IR. Companies believe that current financial and non-financial disclosure is adequate, but at the

same time they have significant expectations for IR. This suggests that IR is perceived as a disclosure tool that is at the same time different and complementary, compared to current reporting. With this perspective, companies and the IIRC share a similar vision: IR should not substitute, but rather complement, current corporate disclosure tools such as annual reports, sustainability reports, corporate governance reports, etc.

Companies expected IR to improve internal strategy communication and integrated thinking. Therefore, they consider IR to be a holistic disclosure tool, potentially providing benefits not only in terms of external disclosure, but also internally. This may be the key element that distinguishes IR and current corporate disclosure tools from the companies' perspective. Current reporting is "adequate", but is missing (among other elements) a clear link with the internal dimension of the corporation. Current academic literature has not yet fully recognized the importance of the internal IR dimension in terms of internal reporting, communication, motivation and integrated thinking. Studies that have focused on IR (see Abeysekera (2013), Frias-Aceituno et al. (2014), Adams and Simnett (2011), Adams (2015), de Villiers et al. (2014), Flower (2015), Higgins et al. (2014) and Lozano (2013)) have been mainly focused on the external dimension of reporting, with some exceptions, such as the works by Stubbs and Higgins (2014) and Lodhia (2015). They mainly draw upon analyses of reports and formal documents, rather than engaging directly with firms. Instead, scholars should focus on the effect of IR on internal reporting and organizational change, thus providing a new perspective to IR research.

IR cannot be implemented entirely by a single function, but rather needs the cooperation of the top management and all the other functions, as the relevant information is likely dispersed throughout the whole organization. According to our results, companies experienced difficulty in obtaining disseminated information, and this confirms the existence of silo thinking. One of the aims of IR is precisely the evolution from silo thinking to integrated thinking, defined as "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"

(IIRC 2013a). The exercise of trying to gather internal information in order to prepare an IR may lead to significant internal learning processes and benefits, given that effective decision-making requires companies to be able to supply each decision maker with necessary information, often held by different organization functions.

One of the main objectives of the present analysis is to gather information on the expectation gap IR has generated. IR aims to provide information on the company's strategy, corporate governance, performance and prospects in such a way that reflects the commercial, social, and environmental context in which it operates in a composite, organized and cohesive form (see Frias-Aceituno et al. 2012). Given the ambition of such a premise, IR may have caused some expectation gaps.

The results of our analysis suggest that investors have experienced the main expectation gap. Companies generally reported some kind of benefit coming from IR implementation, and this is confirmed by the results of our questionnaire, in which all companies agreed that IR did have some significant effect. Conversely, investors are not fully satisfied with the way in which Italian companies have implemented IR. They believe that the performance disclosure is still unbalanced and that the connectivity principle has not been properly applied. This result needs to be interpreted in light of investors' confidence that IR is the future of corporate reporting and that IR is a very useful tool in assessing a company's ability to create value in the short, medium and long term. In other words: investors believe that IR has great potential and could really make a difference in the way companies disclose information to investors. Nevertheless, they are not satisfied with the way IR is being implemented nowadays. Investors therefore see a significant gap between theory (IIRC Framework) and practice.

The divergent view between companies and investors on the effects of IR needs to be interpreted by taking into account the different perspectives of these two groups of subjects. In particular, we need to consider that investors mainly refer to the external IR dimension, that is the Integrated Report, when providing their assessment of IR. Instead, companies also have experience in the internal IR dimension, that is, in the IR process. Our results may therefore suggest that IR has already provided significant benefits internally, and this is confirmed by the fact

that companies reported better internal strategy communication and improvement in integrated thinking. External IR benefits may require more time to be observed, given that providing useful information to investors does not only require internal communication, but also adequate measurement. Looking at the external IR dimension, companies reported that IR allowed them to improve their image. This is consistent with the idea of IR drawing the attention of the market towards the state-of-the-art corporate disclosure and long-term orientation, but at the same time, this is not what investors require.

Looking at the future challenges IR will have to face in order to become a widespread corporate disclosure tool, it seems that the issue of measurability will play a central role. This issue is very important in order to remedy the investors' expectation gap and, at the same time, companies listed it as one of the main challenges to IR implementation. As was argued by Mio in Chap. 2, academic researchers will have to play a significant role in this field, in order to help companies achieve significant measurements of the stock and flow of their capitals. The IIRC may consider issuing some guidance about the process to be followed to create meaningful KPIs, rather than providing a list of pre-determined indicators. This would make it possible to maintain a principle-based approach and also to answer to the relevant needs of companies. It is important to stress that these results provide a description of the scenario as of 2015, but the situation is rapidly evolving. Therefore, more research is needed in order to provide updated results over time.

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