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Determinants and Effects of Integrated Reporting adoption – the case of European companies

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Contents

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Thesis Summary

The current thesis aimed to contribute to existing knowledge on **Integrated Reporting** (IR), enriching the current trend of researching the *determinants* and *effects* of IR (Vitolla *et al.*, 2019a), through an empirical study in a voluntary setting (Europe) and focusing on environmental and social sensitive companies. The voluntary implementation of IR was measured through an alignment score previously used and validated in a mandatory setting studies, being externally validated with IIRC personnel and investors, which enhances its validity.

The **first chapter** unveils the evolution of corporate reporting, from a purely financial perspective to a multi-facet perspective which embeds non-financial information, presented both in an integrated manner or in stand-alone reports. Stand-alone financial reporting lost its information function over time by becoming more technical, not satisfying the information needs of both shareholders and stakeholders. Consequently, companies started to issue other corporate non-financial reports among their traditional financial reports, mainly on their environmental and social aspects. Non-financial reporting evolved from the "triple bottom line" of sustainability reporting towards ESG, GRI, and Integrated Reporting. Both mandatory (Eisenhardt, 1989; Healey & Palepu, 2001) and voluntary reporting (Meek *et al.*, 1995, Cormier & Magnan, 2007) aims to reduce information asymmetry between the management of the company and its shareholders or investors (Leuz & Wysocki, 2016). Therefore, IR can be viewed as a communication tool with shareholders and investors (IIRC, 2013). While traditional financial reporting has mainly an information function (Serafeim, 2015), IR aims to improve the information quality available to financial capital providers, enabling a more efficient and productive capital allocation (IIRC, 2013).

The first chapter also explores the evolution of and towards integrated reporting from the triple bottom line to todays' IIRC Framework. In this regard, we have identified four documents and moments contributing to the Integrated Reporting transformation: (i) King

Code of Corporate Governance Principles from South Africa, in 1994; (ii) Value Reporting Framework of PricewaterhouseCoopers, in 1999; (iii) One Report book of Eccles & Krzus, in 2010; respectively (iv) IIRC Framework, in 2013. Other studies identify various stages in the IR evolution, using a *temporal perspective* (Gibassier *et al.*, 2019) or from a *research perspective* (Rinaldi *et al.*, 2018; Dumay *et al.*, 2016).

Previous literature highlights that the most used theoretical perspectives concerning integrated reporting research are ***stakeholder, institutional, agency, and legitimacy theory*** (Kannenberg & Schreck, 2019; Pavlopoulos *et al.*, 2019; Eccles *et al.*, 2010b; Nicolo *et al.*, 2019; Dragu & Tiron-Tudor, 2014; Speziale, 2019; Vitolla *et al.*, 2019a). We whiteness that most appropriate theories in the loop of Integrated Reporting are shareholder and stakeholder, as this concept embeds both these theories (Eccles *et al.*, 2010b). Additionally, previous studies underline that shareholder and stakeholder theories are the most appropriate to explore the IR phenomenon (Dragu & Tiron-Tudor, 2014). Following our literature review, based on the frequency of usage in the analysed studies, we underline that the most used theories both in determinants and effects studies are agency and stakeholders.

Shareholder theory is embedded in the *IIRC Framework*, through its ***stated primary purpose*** of explaining to providers of financial capital how the organization creates value over time, aiming "*to improve the quality of information available to providers of financial capital*" (IIRC, 2013, p.4). By comparison, ***stakeholder's theory*** is embedded in the *IIRC Framework* through its ***guiding principles*** (stakeholder relationships), ***used capitals*** (social and relationship capital), and ***content elements*** (organizational overview and external environment, governance, business model, strategy and resource allocation, performance, basis of preparation and presentation). Moreover, integrated reporting adoption and implementation empowers stakeholder theory (Pavlopoulos *et al.*, 2019).

Early adopters of IR appeared around 2000s, while 2010 - 2013 period led to IR spreading in various regions and consolidated as a practice after 2013 with the IIRC Framework. Various frameworks and guidelines aim to help companies disclose their social (ISO 26000) or environmental impact (CDP, TCFD, EMAS). Others seek to help organizations disclose their economic, environmental, and social impact (GRI) or sustainability issues (SASB, SDG). Nevertheless, similar to financial reporting, non-financial reporting needs an internationally accepted framework which could lead to uniformity and ensure the relevance, usefulness, and comparability (Bonson & Bednarova, 2015).

The ***current trend in integrated and sustainability reporting*** is of consolidation and alignment, highlighting the interdependencies and synergies between them. To enhance its efforts in developing a global, comprehensive corporate reporting system, IIRC established various collaborations, with: (i) GRI in 2013 - aiming to issue a global reporting standard by defining a universal framework based on harmonized disclosure requirements and guidelines (IASPlus, 2013), (ii) with CDP, CDSB, GRI, and SASB, in 2018 - on how can better help organisations in preparing climate-related and ESG disclosures; and 2020 – aiming to join forces towards a more comprehensive corporate reporting (IIRC, 2020a); and (iii) European Commission in 2020 - regarding the elaboration of Corporate Sustainability Reporting Directive (IIRC, 2020b). Moreover, IIRC and ICAS issued a report in 2017 that shows the complementarity of IIRC Framework (IIRF) and Sustainable Development Goals (SDGs), and in 2020 IIRC launched a revision process of IIRF targeting changes related to the business model, responsibility for an integrated report, assurance, and role of technology (IIRC, 2020c). Furthermore, to consolidate its position, IIRC and SASB communicated in November 2020 their intentions to merge in one organization - Value Reporting Foundation. Thus, we can observe worldwide convergence initiatives to simplify and align the corporate reporting system (IIRC, 2020d).

The first chapter ***comparatively analyses four non-financial frameworks***: ISO 26000, GRI G4, IIRC Framework, EU Directive on non-financial reporting. Even though there are various standards on CSR, environmental and social information reporting, we chose ISO and GRI as literature highlights that they have common goals (Kocmanová & Šimberová, 2013). Additionally, GRI G4 is a continuation of ISO 26000, bringing specific disclosure requirements to ISO's reporting norms (ISO & GRI, 2014). Furthermore, literature whiteness that IIRF is built on the GRI Guidelines (Hřebíček *et al.*, 2012). Nevertheless, there are also other standards and initiatives on CSR, environmental, and sustainability reporting, but we chose to select the one issued before IIRC Framework. Finally, the NFRD of the European Parliament and Council was selected for further analysis as the empirical study's focus is on European companies. Moreover, the EU Directive sets a unified context and regulations on financial and non-financial reporting for European companies. Nevertheless, NFRD has flexible approach - companies can choose out of various guidelines and frameworks to implement the NFRD, even the IIRC Framework.

The comparative analysis of standards highlights that IIRF: (i) presents the most holistic, complete, and complex definition of stakeholders; (ii) has main contribution on integrated thinking (GRI, 2014) - the framework being built around the concept of integrated thinking (IIRC, 2013); (iii) firstly introduced the value creation process into corporate reporting (Albu *et al.*, 2013; Cheng *et al.*, 2014). Regarding primary focus and audience of these standards, we highlight that the primary focus of ISO and GRI is on stakeholders, while IIRF and NFRD have the primary focus on investors and the secondary focus on various stakeholders.

We whiten that ISO 26000 comprises *seven core subjects*, GRI G4 of *nine content or disclosure elements*, IIRF embeds *eight content elements*, while NFRD includes *six content elements*. Regarding principles, ISO 26000 embeds *seven key principles*, GRI G4 is based on *ten principles*, IIRF embeds *seven guiding principles*, while NFRD has *six key principles*. Following the close analysis of these standards, we conclude that IIRC Framework embeds entirely or partially the ISO 26000's core subjects and key principles, GRI G4's disclosure elements and principles, which are further translated into the NFRD. Moreover, IIRC Framework has a principle-based approach, giving space to managers to implement the integrated reporting in a tailored manner (de Villiers *et al.*, 2017).

Even ISO 26000 standard and GRI G4 guidelines have brought major improvements to integrated reporting evolution, **Integrated Reporting** was as a natural step in the evolution of corporate reporting. IR developed from CSR and sustainability fundamentals, embedding both financial and non-financial information. Therefore, **we focused the literature review and empirical study on the Integrated Reporting**, as it represents a growing phenomenon into corporate reporting field.

The **second chapter** explores the Integrated Reporting determinants and effects using a systematic literature review, a method also used in previous literature (Velte & Stawinoga, 2017; Kannenberg & Schreck, 2019; Vitolla *et al.*, 2019a). The previous literature review highlights a shift in IR research approach, from potential benefits and limitations – specific for the 2011-2014 period – towards identifying determinants and effects of IR adoption in more recent years (Vitolla *et al.*, 2019a). Moreover, it evidences the usage of *legitimacy*, *stakeholder*, *agency*, *signaling*, and *institutional* theories for integrated reporting research (Kannenberg & Schreck, 2019; Vitolla *et al.*, 2019a). Researchers underline that determinants of IR quality are not sufficiently studied (Vitolla *et al.*, 2019a; de Villiers *et al.*, 2017; Kannenberg & Schreck, 2019), board of directors' characteristics being of high interest as determinant along with capital market effects (de Villiers *et al.*, 2017). Literature also indicates to focus on multi-country and multi-period samples (Velte & Stawinoga, 2017).

Following the ***literature review on Integrated Reporting determinants***, we observe that majority (43%) of studies are focused on IR quality determinants, followed by IR adoption and IR alignment level to IIRF. Moreover, all the studies in the sample are quantitative, the majority of them being focused on worldwide samples, and few use single-country samples. The most used theories in determinants studies are agency, stakeholder, institutional, legitimacy, signaling, and voluntary disclosure, while the majority of articles are on a voluntary-based IR setting (78%). We have identified ***three levels of determinants***: *company*, *industry*, and *country*; ***company level determinants being the most analyzed*** (83%) in previous studies, and of them, *board of directors' characteristics* being the most encountered (45%). Observed results highlight that IR adoption and implementation is ***positively impacted by***:

- **company level:** *Financial determinants*; *Corporate governance determinants*; *IR related determinants*; *Corporate characteristics' determinants*;
- **industry level:** *basic materials, consumer products and services, environmental sensitive, financial, industrials, manufacturing, mining, property, services, telecommunications*; but ***negatively impacted by***: *consumer goods and oil & gas*;
- **country level:** *Country specific systems*; *Hofstede cultural characteristics*.

Literature review of Integrated Reporting effects highlights the main focus on IR adoption (46%), pre and post IR adoption effects for the same companies, and adopters vs. non-adopters. The majority of studies (87%) are quantitative and are focus on the voluntary IR setting (63%). We also observe a shift from mandatory towards the voluntary setting, as researchers aim to identify potential effects of IR adoption in other jurisdictions, advocating for the endorsement of IR practice as an institutionalized corporate behaviour. The most used theories in the IR effects studies are agency, voluntary disclosure, stakeholder, information asymmetry, and signaling. We have identified ***two levels of effects***: *market* and *company*; ***market-level effects being the most analyzed*** (71%). Moreover, *company value* and *analysts' earnings forecasting precision* being the two most encountered means to evaluate IR market effects (39%). This observation underlines the strong market orientation of integrated reporting, financial capital providers being one of the most important stakeholders for the company (IIRC, 2013).

Following literature analysis, we observed the ***market-level effects of IR adoption and implementation***:

- **improves:** analyst earning forecast accuracy; company's value; market value of equity; earning quality; company's liquidity; ESG disclosure, reporting, score; and
- **reduces:** analyst earning forecast error; cost of capital; cost of debt; company's market risk exposure.

If we consider the company-level effects, we observe that from a ***quantitative perspective***, IR adoption and implementation:

- **improves** corporate governance function,
- **reduces** company's risk (leverage), and
- **impacts** the company's financial performance (undecisive).

From a qualitative point of view, we observe that **IR adoption and implementation:**

- Integrated Reporting improves the measurement focus of management control due to company's business model role played throughout integrated reporting development and the adopted process to design the business model;
- High-Performance and GRI companies present equal performance on Sustainability Reporting and Integrated Reporting practices, but are lower than IIRC companies;
- US companies exhibit lower compliance with Sustainability Reporting and Integrated Reporting practices, and present less information in their Sustainability Report and Integrated Report as compared to non-US companies;
- did not stimulate innovation in disclosure mechanisms, but produced incremental changes to processes and structures previously used for sustainability reporting;
- leads to decisions with higher sustainable value creation;
- business model and Strategy were not disclosed before mandating IR in South Africa, but were disclosed after;
- companies present more transparently their strategic objectives, even so not correlate them with business model, KPIs, opportunities, or risks.

Based on results emerging from the literature review, the thesis further developed a detailed analysis of company-level determinants – *via board of directors' characteristics* - and market-level effects – *via company value and analysts forecast errors* - of integrated reporting adoption and implementation.

The most analysed *board of directors' characteristics* in the observed studies are related to *size*, *independence*, *diversity*, *activity*, *tenure*, and *CEO duality*, also *further used for the empirical research*. Observed results from previous studies highlight that IR adoption and implementation is positively impacted by board's: size, diversity (gender), independence, activity, tenure, and CEO duality. The most used theories in these studies are *agency* and *stakeholders*.

Company value and *analysts' earnings forecasting precision* are the two most encountered means to evaluate the market level effects of integrated reporting adoption. Overall results highlight that company value is positively impacted by IR adoption and implementation - *symbolizing an improved value creation process of the company* - and IR adoption and implementation reduce the forecasting errors - *translated into an enhanced information environment and mitigating the agency problems*. The most used theories for *company value* studies are *stakeholders* and *proprietary disclosure costs*, while for *analysts' forecast precision*, the most used theories are *voluntary disclosure* and *agency*.

Previous studies highlight that in a *mandatory setting, IR adoption and implementation enhances the value of the company, effect which is mixed in case of the voluntary setting*, where IR adoption (i) can improve (Gal & Akisik, 2019), (ii) has no influence (Wahl *et al.*, 2020) or even (iii) has a negative influence (Landau *et al.*, 2020) on company value. Nonetheless, companies could use additional mechanism to enhance firm value into voluntary setting, for example, by externally assuring their integrated reports.

Following the literature review, we observe that *mandating IR can reduce analysts' earnings forecasting errors* (Bernardi & Stark, 2018; Zhou *et al.*, 2017; Baboukardos & Rimmel, 2016). However, the positive effect being most likely to *occur into a mandatory setting* (Bernardi & Stark, 2018; Zhou *et al.*, 2017) than a *voluntary one* (Hurghiș, 2020; Wahl *et al.*, 2020) – where *IR adoption is not found to improve the company's information environment*. Therefore, in a voluntary setting, IR implementation has (i) a negative impact on analysts' forecast error accuracy (Hurghiș, 2020), (ii) no significant effect on analyst earnings forecast accuracy (Wahl *et al.*, 2020), respectively IR adoption (iii) enhances the ability of analysts' to produce accurate earnings forecasts (Flores *et al.*, 2019). Additionally, we found that IR is a communication tool that can mitigate agency problems (García-Sánchez & Noguera-Gámez, 2017).

The **third chapter** aims to empirically analyse the *company-level determinants* and *market-level effects* of *Integrated Reporting adoption and implementation*, presenting how the alignment level of integrated reports with the IIRC Framework was measured. The empirical study focuses on controversial industries (environmental and social sensitive companies) from the unified European context, where IR is adopted voluntarily. We focused on the European context as the literature review highlights a weak focus on European companies only (Gibassier *et al.*, 2019; Grassmann, 2021), even though (i) majority of integrated reports from IIRC example database are produced by companies headquartered in Europe (35%) (IIRC, 2021a) and (ii) only 10 out of 78 studies in our literature review focuses only on the European companies. Additionally, 55 out of 78 studies (71%) are made in a voluntary setting, but the focus is on worldwide samples, while most studies using stand-alone country are focused on South Africa (Velte & Stawinoga, 2017), where IR is mandated – fact strengthen through our literature review (12 out of 78 studies).

The current chapter discusses the controversial industries composing the analyzed sample, as they were pioneers in disclosing their environmental impact back in the ‘80s (Patten, 1991) and early adopters regarding GRI reporting (Mukherjee & Nuñez, 2019). Environmental sensitive companies bear a high environmental risk (Mukherjee & Nuñez, 2019), while social sensitive companies face legitimacy and credibility problems (Alonso-Almeida *et al.*, 2014). For the empirical study, we analyse the relation between the IR alignment level to the IIRF and BoDs’ characteristics, as determinants, respectively company value and analysts’ earnings forecasting errors, as effects.

Using *content analysis method*, we aimed to analyse the alignment level of the integrated reports with the IIRC Framework (Disclosure Index Score - DIS), using a Zhou *et al.* (2017) developed checklist, which is based on the IIRF, moreover being externally validated with IIRC personnel and investors, enhancing its validity.

The ***descriptive results*** highlight that environmental sensitive companies disclose more information than social sensitive ones, aligning at a higher level to the IIRC Framework. Moreover, the disclosure index score recording higher yearly average values, representing an improvement in IIIR implementation. The highest average scores are recorded for dimensions “*Organizational overview and operating context*”, “*Governance*” and “*Risks and Opportunities*”.

Regarding **company level determinants** of voluntary integrated reporting adoption and implementation, related to **board of director’s characteristics**, we highlight that companies having a *higher board gender diversity* and *a higher proportion of independent directors disclose integrated reports aligning to a larger extent with IIRC Framework.* Through the lenses of ***stakeholder theory***, obtained result underlines that outside director are long-term oriented and concerned about business sustainability, having interests and information needs more aligned to external stakeholders and providing supplementary assurance that companies consider stakeholders’ interests into the decision-making process. Regarding gender diversity, women are using a more careful reasoning, protective attitude towards environment, social responsibility, which are also embedded in the ***stakeholder theory***, that requires a focus not only on the financial capital but also on natural and social and relational capitals (elements encountered also into IIRF).

By contrast, results underline that *a larger board negatively impacts the alignment level of integrated reports with IIRF*. This can symbolize that a large board might function ineffectively, leading to deficient communication and an inefficient decision-making process. Specifically, CEO-Chair role conjunction results in higher voluntary disclosures for environmental sensitive companies, leading to a higher alignment degree with IIRF. Moreover, for these companies, a board formed in a higher proportion of non-executive directors disclose integrated reports that align at a lower degree with IIRC Framework.

Obtained results for both **board independence** and **gender diversity** are ***in line with previous studies*** findings, while those obtained for **board size** are ***contrary to previous literature***.

Regarding the **market level effects** of integrated reporting voluntary adoption and implementation, we explored the relation between Disclosure Index Score and **company value**, respectively **analysts forecast errors**. We discovered *a positive relation between company value and Disclosure Index Score*, indicating that a higher alignment level of integrated reports to IIRC Framework is translated into higher company value. Consequently, the related benefits of IR adoption and implementation exceed the proprietary costs and disclosed competition-sensitive information, improving company's value creation process. Dimensions *"Risks and Opportunities"* and *"Other elements"* were found to impact the most the value of the company. Additionally, we found *a negative relation between analysts' forecast errors and Disclosure Index Score,* indicating that a higher alignment level with IIRC Framework helps analysts reduce forecasting errors. Thus, analysts can embed the disclosed information into integrated reports in their forecasts. Dimensions *"Strategy and Resource Allocation"* were found to impact the most the analyst's forecast errors. Through the lenses on ***shareholder theory***, obtained results highlight that Integrated Reporting adoption and implementation, enhances the company's information environment and reduces information asymmetry, strengthening the view that financial capital is the most critical factor for the company. Therefore, these results reaffirm the integrated reporting primary aim to explain to financial capital providers how the company creates value over time, also improving "*the quality of information available to providers of financial capital*" (IIRC, 2013, p. 4). Analysing

Our results regarding both **company value and analysts' forecast errors** are ***contrary to those previously obtained in a voluntary IR setting*** but ***are are similar to those obtained into mandatory IR setting***.

The similarity of our results, for voluntary IR setting, with those obtained into a mandatory IR setting could be explained through the fact that we use a validated disclosure index score, both externally with investors and IIRC personnel and in previous IR mandatory studies. By comparison, following our literature review, we observed that other studies focusing on voluntary IR setting use disclosure index score that are not externally validated nor being based solely on IIRC Framework. This could moreover explain the contrasting results obtained through our empirical research into voluntary setting to others obtained also into voluntary IR setting. Furthermore, this difference could also be explained by focus of the sample: we include only publicly listed companies headquartered in Europe, which offers a unified context in term of rules and laws, while majority of previous studies use a worldwide sample which is very heterogeneous, without having a common base for their rules and laws.

Our research **contributes to existing knowledge into Integrated Reporting field** by: (i) exploring IR adoption and implementation in a voluntary setting, (ii) aligning to quantitative studies that analyse IR, (iii) focusing on the unified European context, (iv) analysing the company level determinants of IR adoption and implementation, (v) analysing the market level effects of IR adoption and implementation. Moreover, we bring novelty for the voluntary IR setting empirical analysis by using Zhou *et al.* (2017) validated alignment score into mandatory setting studies, being externally validated with IIRC personnel and investors, enhancing its validity, and possibly explaining our similar results to those obtained into mandatory IR setting.

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