Special Write-Up

Research Insights into Integrated Report Quality vis-à-vis Capital Market & Real Effects: Global Perspective

The International Integrated Reporting Council's Framework identifies two goals for integrated reporting: improved information for outside providers of financial capital and better internal decision making. The authors extend prior research that finds a positive association between integrated report quality (IRQ) and firm value by examining two channels through which this association may arise—a capital market channel and a real effects channel. To conduct these tests, the authors disaggregate firm value into three components: liquidity, cost of capital, and expected future cash flows. Using data from South Africa where integrated reporting is mandatory and an IRQ measure based on proprietary EY data, the authors find a positive association between IRQ and liquidity, which supports the capital market channel. The authors find no evidence of a relation between IRQ and cost of capital. The authors find higher IRQ is (not) associated with higher realised future operating cash flows (greater analyst target price forecast accuracy), and find higher IRQ is associated with higher investment efficiency. These findings support the real effects channel. Together, the authors' findings are consistent with integrated reporting achieving its dual objective of improved external information and better internal decisions.

Since the release of the International Integrated Reporting Framework in 2013, worldwide interest in integrated reporting continues to grow. According to the International Integrated Reporting Council (IIRC), more than 1,500 organisations are adopting integrated reporting, including high profile names such as AES Brasil, Clorox, GE, Mitsubishi, Novo Nordisk, Tata Steel, and Vivendi.

There has been strong support for integrated reporting from large accounting firms as well as standard setters and professional accountancy organisations in various countries. Among regulators, the IIRC's Framework was recently endorsed by China's Ministry of Finance, and the Securities and Exchange Board of India (SEBI) is encouraging the top 500 listed companies in India to voluntarily adopt integrated reporting. The IIRC continues to move towards the "global adoption" phase of its strategy, the goal of which is to make integrated reporting the

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norm. Against this backdrop, empirical evidence on the benefits associated with integrated reporting is needed.

In a 2017 *Accounting, Organizations and Society* article (Vol. 62, p. 43-64), we address the question of how integrated report quality (IRQ) is associated with firm value by identifying and empirically assessing two channels for the positive association between IRQ and firm value:

1. A capital market channel that relates to higher quality information for outside providers of capital.
2. A real effects channel that relates to higher quality internal decision making.

We focus on these channels because of the two objectives included in the IIRC's Framework: (1) improving the quality of information available to outside providers of financial capital to enable a more efficient capital allocation, and (2) supporting integrated internal thinking, decision making, and actions that focus on value creation for the organisation over the short, medium and long term.

In contrast to accounting standards or other types of disclosure regulation, such as the US Security and Exchange Commission (SEC) Form 10-K, integrated reporting has the dual objective of providing information to both external and internal decision makers. Our objective is to shed light on the extent to which, and how, integrated reporting achieves this.

Our evidence is based on IRQ scores determined by a team of professors at the University of Cape Town for the purpose of supporting EY's annual Excellence in Integrated Reporting awards in South Africa, which is the only country that mandates integrated reporting.

Findings from our study include:

- Confirmation that there is a positive association between IRQ and firm value.
- Higher IRQ is associated with greater liquidity, a capital market effect, and higher expected future cash flows, a real effect.
- There is no evidence of a relation between IRQ and cost of capital—another capital market effect.

The expectation of higher future cash flows for firms with higher IRQ is borne out by higher future realised operating cash flow. But analysts' target price forecast accuracy is not, which adds support for the real effects channel, as does finding that IRQ is positively associated with firms' investment efficiency.

Importantly, the relations we document include controls for the issuance of a standalone corporate social responsibility (CSR) report as well as accounting quality and overall disclosure quality, among other factors. These relations reveals that high quality integrated reports are associated with benefits incremental to those associated with existing reports, such as standalone CSR reports.

In addition, to provide insights into which features of integrated reports are associated with firm value, we mapped the IRQ evaluation criteria EY uses to rate the reports into 12 categories that reflect the guiding principles and content elements of the IIRC's Framework. Based on this, we found that connectivity, stakeholder relationships, materiality, and conciseness are the most important drivers of the findings for firm value and for its liquidity and expected cash flow components. The importance of connectivity is particularly pertinent because connectivity is closely linked to integrated thinking, which is key to achieving the dual objective of providing information to both external and internal decision makers.

Managers, practitioners, standard-setters, regulators, investors, and other interested stakeholders should find these results noteworthy in evaluating the merits of integrated reporting. The European Commission, the US SEC and other regulators have expressed interest in integrated reporting and the results of this research could help inform their deliberations on its future in their jurisdictions.

The IIRC may also find the research results encouraging as it promotes the global adoption of integrated reporting. Investors, particularly institutional investors with policies for responsible investment, may also find the results of this research informative in evaluating their resource allocation decisions. ■

(Courtesy: IFAC's Global Knowledge Gateway)