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EARLY EVIDENCE ON THE ECONOMIC CONSEQUENCES ASSOCIATED WITH INTEGRATED REPORT QUALITY

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KEY CONCLUSIONS

- We find a positive association between integrated report quality (IRQ) and both stock liquidity and firm value.
- Further, we decompose firm value into two components – expected future cash flows (numerator effect) and cost of capital (denominator effect). We find that IRQ is positively associated with expected future cash flows, while we find no evidence on the association between IRQ and the cost of capital.
- Thus, on balance, our evidence suggests that the association between IRQ and firm value is mainly driven by increasing expected future cash flows, consistent with investors revising their estimates of future cash flows upward because they have a better understanding of the firm's capitals and business strategy or with integrated reporting leading to better decisions being made by managers as a result of "integrated thinking".
- We probe these two explanations for our expected future cash flows results and find that IRQ is positively associated with ex-post operating cash flows, but has no association with target price accuracy.
- Finally, we repeat our main analyses by decomposing IRQ into individual components linked to the IIRC's integrated reporting framework. We find that the components related to connectivity, stakeholder relationships, materiality, and conciseness are the most important drivers of our main results.

ABSTRACT

We examine whether integrated report quality (IRQ) is associated with stock liquidity, firm value, expected future cash flow, and cost of capital.

Our study is motivated by the recent focus on sustainable capitalism and the global interest shown by firms, investors, and regulators in the work of the International Integrated Reporting Council (IIRC). We use data from South Africa because it is the only country where integrated reporting is mandated. We use a measure of integrated report quality based on proprietary data from EY who rate these reports as part of its Excellence in Integrated Reporting awards. We find that integrated report quality is positively associated with both stock liquidity (measured using bid-ask spreads) and firm value (measured using Tobin's Q). Our results are consistent whether we analyze levels or changes. When we decompose the firm value into an expected future cash flow effect and cost of capital effect, we find that the positive association between integrated report quality and firm value is driven mainly by the cash flow effect, consistent with investors revising their estimates of future cash flows upward as a result of a better understanding of the firm's capitals and strategy or future cash flows increasing because of improved internal decision making by managers.

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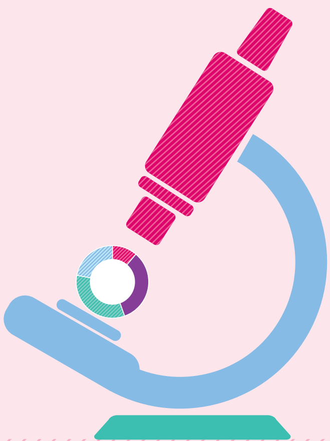

INTRODUCTION

An integrated report is defined by the International Integrated Reporting Council (IIRC) as a "concise communication about how an organization's strategy, governance, performance and prospects lead to the creation of value over the short, medium and long term" (IIRC, 2013, 7).

In their article "A Manifesto for Sustainable Capitalism", former US Vice President Al Gore and David Blood (2011) call for mandatory integrated reporting, which they see as an essential change to support a "sustainable capitalism" in which firms focus on long-term value creation. They argue that investors can use integrated reports, which provide a comprehensive view of the firm, to help them make resource-allocation decisions. Gore and Blood (2011) acknowledge that such reporting on a voluntary basis is becoming more common, but believe that to ensure more rapid and general adoption, the use of integrated reports needs to "be mandated by appropriate agencies such as stock exchanges and securities regulators".

We undertook a study as part of a research project funded by the CIMA South Africa Centre of Excellence to provide early evidence on the economic effects associated with the quality of mandatory integrated reports, in respect of firms' stock liquidity, their value, their expected future cash flows, and their cost of equity capital. This report summarizes the main findings.

RATIONALE FOR THIS STUDY

The aim of our study is to increase understanding of the implications of integrated reporting as a new reporting framework. This kind of reporting is gaining popularity in many firms, in several countries, and at the international level.

Thus far, more than 100 leading multinationals, including Deutsche Bank, HSBC, National Australia Bank, Pepsi, Unilever and Tata Steel, have already participated in the IIRC's voluntary pilot integrated reporting program. Moreover, professional bodies and standard-setters in Brazil, India, Japan, Singapore and Australia have indicated support for integrated reporting, although some of this support is arguably more rhetorical than actual. International organizations such as the Business 20 (B20) Summit and the European Commission have released statements supporting integrated reporting. Furthermore, the FASB and IASB have begun to engage with standard setting bodies, including the IIRC, to focus on alternative disclosure models as part of the Corporate Reporting Dialogue. However, currently, there is little empirical evidence on the possible benefits of integrated reporting. It is therefore important that academics join the debate and attempt to supply empirical evidence in this regard.

RESEARCH DESIGN

We examine the association between integrated report quality (IRQ) and a firm's value, stock liquidity, expected future cash flows and cost of capital. We use a sample of South African firms because so far South Africa is the only country where integrated reporting is mandatory.

Integrated reporting became effective for firms listed on the JSE for annual periods beginning on or after 1 March 2010. Our sample includes the top 100 firms on the JSE based on market capitalization on 31 December 2011, 2012, 2013 and 2014 respectively. We start in 2011, because this is the first year in which the EY's Excellence in Integrated Reporting Awards, which we use to construct our integrated report quality proxy, were made. Our sample consists of the 80 firms which were included in the EY awards across all four years. We use a constant sample because we want to ensure our IRQ measure is not affected by changes in the EY sample composition across years. The sample for the stock liquidity and firm value models consist of 292 firm-year observations representing 79 firms. Due to additional data constraints of analyst forecasts, the sample for the cost of capital (expected future cash flows tests) consists of 221 (189) firm-year observations representing 65 (59) firms.

To measure IRQ, we use proprietary data from EY, who annually rate the quality of the integrated reports of the top 100 firms that are listed on the Johannesburg Stock Exchange (JSE). Since the 2011 fiscal year, EY evaluates the integrated reports of the top 100 firms on the JSE against a list of criteria based on the IIRC Framework (or a draft thereof prior to it being issued).

We evaluated the score sheets used by the adjudicators for consistency with the IIRC Framework and we believe that it is an appropriate measure for integrated report quality. Graham (2014, 16), the chair of the adjudication panel, states that the "marking process is not simply about 'ticking the box'. More emphasis is placed on the quality of information presented – the relevance, understandability, accessibility and connectedness of that information, whether users of the integrated reports would have a reasonable sense of the issues that are core to the operations of each of the companies, and whether companies have dealt with the issues that users would have expected."

The integrated reports are evaluated by three adjudicators who have extensive experience in reading and evaluating firms' corporate reports. Two of the adjudicators have been involved in the EY Excellence in Integrated Reporting Awards and the preceding EY Excellence in Corporate Reporting Awards since its inception in 1997, while the other adjudicator has been involved since 2005 (EY, 2014). Hence, the three adjudicators were the same during our sample period.

OUR FINDINGS

Our findings show that IRQ is positively associated with stock liquidity and firm value after controlling for accounting quality, corporate governance, corporate social responsibility performance (CSR), the issuance of a standalone CSR report, firm complexity, overall disclosure quality, and other factors.

Next, we decompose firm value into a numerator effect (expected future cash flows) and a denominator effect IRQ can increase a firm's value. The results suggest a significant and positive association between expected future cash flows and IRQ. We also estimate cost of capital using the average of four commonly used cost of capital proxies. The evidence finds no relation between IRQ and the cost of capital.

Thus, we conclude that IRQ affects firm value, mainly through expected cash flows. IRQ may help investors to understand a firm's strategy and business model better, enabling them also to estimate future cash flows better. Moreover, integrated reporting may affect the way management thinks – often referred to as "integrated thinking" – which may in turn lead to better operational and investment decisions, which then generate higher cash flows.

We probe the cash flow channel further. Firstly, we investigate whether IRQ is positively associated with ex-post realized actual operating cash flows. We find a positive and significant association between IRQ and one-year ahead, two-year ahead operating cash flows and the sum of the two years, respectively.

Next, we investigate whether IRQ is associated with target price forecast accuracy. If integrated reporting improves investors' ability to forecast future cash flows more accurately, we expect to observe a negative association between IRQ and target price forecast errors. We do not find any evidence to support this association.

Finally, we decompose IRQ into its components. Our evidence suggests that the connectivity, stakeholder relationships, materiality, and conciseness components are the most important drivers of our main results across our liquidity, firm value and expected future cash flow results.

Overall, our study suggests that high quality integrated reports are associated with positive economic consequences.

CONCLUSION

Our study should be of interest to firms, investors, regulators, and the IIRC, because the findings suggest that positive economic benefits are associated with using the integrated reporting model, even when its use is mandated. Our findings indicate that these benefits could result from more holistic and comprehensive presentation of information and also from changes in firms' decision-making. The complete version of our study is available online at: papers.ssrn.com/sol3/papers.cfm?abstract_id=2699409

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