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Value creation, CEO incentives and remuneration: evidence from integrated reporting adopters

University of East Anglia

Contents

Key conclusions

The Integrated Reporting <IR> adopters in our study.

- Have shifted from a focus on short term financial targets and performance to favour more balanced performance objectives.
- Are more likely to link CEO compensation to long term and non financial (human, intellectual, social and natural) targets.
- Are using <IR >as the preferred vehicle to disclose compensation policies.
- Are more transparent about their incentives and remuneration policies.

Our findings also

- Suggest that <IR > adopters implementing such balanced CEO compensation policies and performance objectives achieve superior integrated performance and better ESG results.
- Illustrate how embracing <IR> and integrated thinking can contribute to long term value creation and organisational success.

Abstract

This study is motivated by the growing importance of Integrated Reporting <IR> as an innovative reporting initiative to foster representation of sustainable value creation over time.

Focusing on the International Integrated Reporting Council's (IIRC) framework on Integrated Reporting <IR>, it examines: whether <IR> adoption is associated with Integrated Thinking, conceived as a long-term and broad concept of value creation focused on financial and nonfinancial capitals (e.g. human, natural, social, or intellectual), as well as with Integrated Performance, a balanced view of results based on economic, environmental, social, and governance (ESG) pillars.

To capture Integrated Thinking, it looks at non-financial and long-term targets in CEO compensation and the presence of 'integrated' strategy and management, while it considers the combined economic, environmental, social and governance scores, as proxies of Integrated Performance.

Evidence shows that, compared to non-adopters, <IR> adopters (as identified in the IIRC's website) are more likely to embrace Integrated Thinking by linking CEO compensation to non-financial targets (human, intellectual, social, and natural) and to the ability to create value in the long term. Furthermore, such firms achieve superior Integrated Performance and better ESG results. Finally, they are also transparent about executives' incentive and remuneration and their link with value creation by mean of the capitals, disclosing such information through the <IR>.

Overall, these results shed light on the potential of <IR> to increase Integrated Thinking and performance measured both in financial and non-financial terms and also show that <IR> plays a role in fostering transparency for remuneration, and more generally for incentives policies.

Introduction

Integrated Reporting <IR> is considered an innovation in corporate reporting, as it involves a single report, primarily for capital providers, that focuses on the ability of an organisation to be sustainable and create value in the short, medium, and long term by means of its capital (financial, human, intellectual, social, manufactured, and natural) (IIRC, 2013).

In so doing, it emphasises the importance of Integrated Thinking within the organisation (where Integrated Thinking is the active consideration of the relationships between various operating and functional units and the capital that the organisation uses or affects). When Integrated Thinking is applied, the integrated report becomes more than the output of a process; it becomes a critical milestone in the continuous journey of improvement in decision making, accountability, and communication (IIRC, 2013).

There is a growing realisation that embracing Integrated Thinking and the reporting cycle envisaged by the <IR> framework can improve long-term organisational success. This is achieved by breaking down internal silos and increasing the shared understanding of how value is created (IIRC, 2016). According to the IIRC, Integrated Thinking leads to integrated decision making and actions that consider the creation of value over the short, medium, and long term. <IR>, thus, seeks to influence corporate behaviour through Integrated Thinking (IFAC, 2015): Integrated Thinking embraces a long-term and broad concept of value creation and of the capitals used and affected by the value creation process that include both financial capital and nonfinancial ones (e.g. human capital, natural). If Integrated Thinking is not embedded in current business practices, there is a risk that <IR> will be a mere symbolic practice or 'just another report' added to the documents already published (CSR reports, governance reports, etc.).

In order to practice Integrated Thinking, it is fundamental that there is a link between remuneration and incentives as well as long-term sustainable value creation (e.g. IIRC, 2013). Specifically, as it is widely acknowledged that incentive systems are crucial to motivate decision makers and to help them understand how to direct their efforts (e.g. Merchant and Van der Stede, 2008), we focus our attention on the design choice for the compensation package among <IR> adopters to reveal whether they engage in Integrated Thinking as an essential business practice.

Our hypothesis is that if <IR> is accompanied by Integrated Thinking, this should be reflected in the compensation packages designed to avoid executive 'short termism' and managerial myopia. The types of objectives included in compensation contracts suggest attention (or a lack thereof) to important elements characterising Integrated Thinking, such as distinct capitals and value creation process, not only in the short term but also in the long run. We focus on CEOs incentives, as they are the most influential decision makers in a company and, therefore, ultimately responsible for a firm's performance; thus, their objectives more directly reflect a firm's goals.

Drawing on previous studies, we also measure Integrated Thinking by looking at some indicators of "integrated strategy and management" provided by Thomson Reuters Asset4, the leading data providers on ESG information (Maniora, 2017). Furthermore, we analyse whether a stronger emphasis on Integrated Thinking, manifested by incentives favouring the integration of long-term, non-financial objectives with short-term, traditional, financial objectives, brings about superior firm performance, both financial and non-financial (e.g. social or environmental).

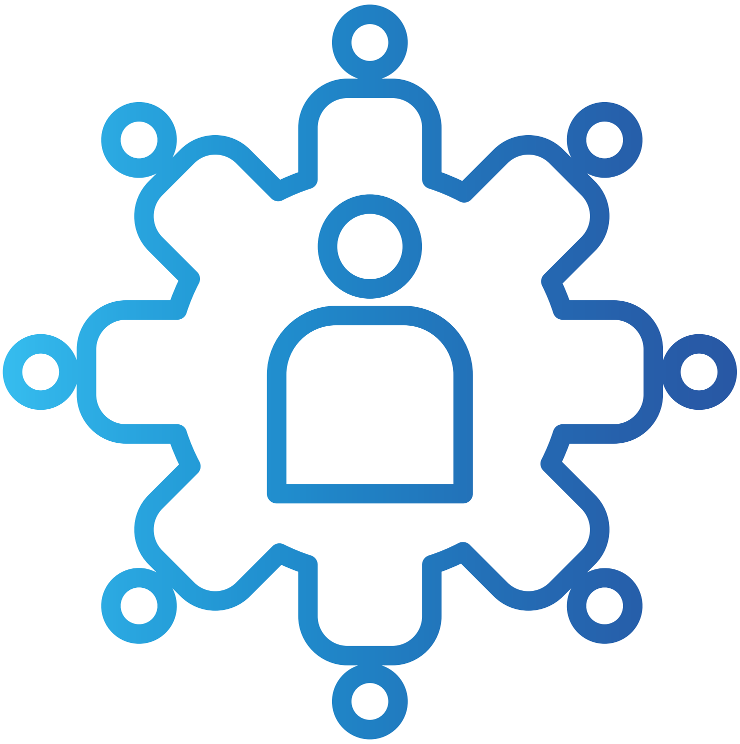
In addition, by analysing <IR> users' disclosures of their remuneration policies, we provide initial evidence on the level of transparency on these issues. An <IR> should indeed, provide insight on how remuneration and incentives are linked to value creation in the short, medium and long term, including how they are linked to the organisation's use of and effects on the capitals (IIRC, 2013).

As far as we know, there is a lack of research on the implementation of Integrated Thinking and <IR> focused on the role of executive incentives and remuneration, despite the call for contributions on this topic from both academics and practitioners (Accounting for Sustainability, 2014; Busco et al., 2013; Serafeim, 2015). Addressing these core issues is now fundamental to understanding the role that <IR> could play in fostering firm behaviours around sustainable business models, and, in particular, in escaping 'short termism' and managerial myopia. Such a long-term orientation is expected to mitigate problems linked to executive compensation that have contributed to recent financial crises.

Objectives

The project aims to collect evidence on and analyse the current practices of <IR> and Integrated Thinking, specifically, with a primary focus on executive remuneration and incentives. In particular, we assess whether the following hold true.

- First, compared to non-adopters, <IR> adopters are more focussed on long-term, non-financial goals as a first signal of the incorporation of Integrated Thinking in firms' practices;
- Second, <IR> adopters have a more 'integrated strategy and management', namely, an overarching sustainability oriented vision and day-to-day decision-making processes as additional evidence related to Integrated Thinking.
- Third, firms that embrace <IR> and Integrated Thinking have higher Integrated Performance (economic and ESG).
- Fourth, <IR> adopters use IR as preferred reporting vehicle to be transparent regarding executive remuneration, incentives, and the link between executive compensation and firm ability to create value in the short, medium and long term.



Research methodology

The population considered is the full sample of <IR> adopters identified in the IIRC's website as "<IR> reporters" and a matched sample of <IR> non-adopters.

<IR> reporters are those organisations who refer to their reports as integrated or participate in <IR> Networks. There are 97 firms in our main <IR> adopters sample, including 291 observations. The matched sample includes 72 firms, and 216 firm-pair-year observations. All the firms in the matched sample are <IR> non-adopters. Peers were identified based on three criteria: industry, size, and continent (when possible).

<IR> adopters come from 13 countries. The majority (62 per cent) of the firms are from South Africa where <IR> has been mandatory since 2009; 22 per cent from Europe, 9 per cent from the UK, and 7 per cent from non-European countries.

<IR> adopters are spread over 10 industries; the most common are industrials (23%), followed by financials (20%), basic materials (19%), and consumer services (12%), representing the top four. The mean revenues of these companies are around 11 million euros.

Non-adopters come from 26 different countries. Over 30 per cent of the firms come from the US; European and non-European firms represent, respectively, 26 per cent and 28 per cent of the sample, while UK firms account for 15 per cent. The matched sample is also spread over 10 industries, the most common of which is basic materials (18%), followed by consumer services (17%), industrials (15%), and financials (15%), as the top four. Their mean revenues are around 12 million euros.

The samples are also similar with reference to the type of remuneration committee structures (91.67% of <IR> adopters and 96.76% of non <IR> adopters have a remuneration committee, respectively).

We collected data for years 2013, 2014, and 2015 based on a content analysis of the corporate reports available on CEO incentives and remuneration. We first downloaded four types of corporate reports—integrated reports (IRs), annual reports, governance reports, or proxy statements (for US firms), and sustainability reports—from the firms' websites.

We then collected our compensation variables from corporate reports searching in the IRs, and if nothing was found, we then moved on to annual reports, governance reports and so forth. In cases where compensation information was scattered in multiple reports, we combined the information.

For the <IR> adopter sample, we used the Integrated Report as reporting vehicle for 59% of the years observation, annual report for 24%, governance report or proxy statements for 9% and multiple reports in the remainder. For the matched sample of non-adopters, we used the annual report as reporting vehicle for 57% of the observations and the governance report or proxy statements for 43%.

We specifically focussed on the type of objectives (financial versus non-financial) and the time orientation (short term versus medium/long-term). In line with the IIRC framework, the types of objectives are defined based on the IIRC definitions of capital: financial, manufactured, natural, human, intellectual, and social and relationship capital (see Table 1). To distinguish between short-term and medium/long-term objectives, we rely on firm reported data, namely, firm definitions of short-term and long-term objectives. If not specified, we consider short-term incentives as those covering a period up to one year and medium/long-term ones as all the others.

We then collected archival data from Thomson Reuters Asset[4] on performance (economic, environmental social, governance, and integrated) and controls.

Data analysis was based on differences in mean t-tests univariate statistical analysis. Details on variable definitions and measurements are provided in Table 2.

Table 1

Type of capital	Definition (IIRC, 2013)
Financial	The pool of funds available to an organisation for use in the production of goods or the provision of services, obtained through financing, such as debt, equity or grants, or generated through operations or investments.
Manufactured	Manufactured physical objects (as distinct from natural physical objects) available to an organisation for use in the production of goods or the provision of services, including buildings and infrastructure (such as roads, ports, bridges, and waste and water treatment plants).
Natural	All renewable and non-renewable environmental resources and processes that provide goods or services that support the past, current, or future prosperity of an organisation, including air, water, land, minerals, and forests, as well as biodiversity and ecosystem health.
Intellectual	Organisational, knowledge-based intangibles, including intellectual property, such as patents, copyrights, software, rights, and licences; and organisational capital such as tacit knowledge, systems, procedures, and protocols.
Human	Human competencies, capabilities, experiences, and motivations to innovate, including alignment with and support for an organisation's governance framework, risk management and ethical values; ability to understand, develop, and implement an organisation's strategy; and loyalties and motivations for improving processes, goods, and services, including the ability to lead, manage, and collaborate.
Social and relationship	The institutions and the relationships within and among communities, groups of stakeholders, and other networks, and the ability to share information to enhance individual and collective well-being. Social and relationship capital includes shared norms and common values and behaviours; key stakeholder relationships and the trust and willingness to engage with external stakeholders that an organisation has developed and strives to build and protect; intangibles associated with the brand and reputation that an organisation has developed; reputation that an organisation has developed and an organisation's social license to operate.

Table 2

Variable definition	Measurement
Integrated Performance	Using an equal-weighted rating, the overall integrated performance reflects a balanced view of a company's performance in four areas: economic, environmental, social, and corporate governance (Asset4 Mnemonic A4IR).
Economic performance	The economic pillar measures a company's capacity to generate sustainable growth and a high return on investment through the efficient use of all its resources. It is a reflection of a company's overall financial health and its ability to generate long-term shareholder value through its use of best management practices (Asset4 Mnemonic ECNSCORE).
Environmental performance	The environmental pillar measures a company's impact on living and non-living natural systems, including the air, land, and water as well as complete ecosystems. It reflects how well a company uses best management practices to avoid environmental risks and capitalise on environmental opportunities in order to generate long-term shareholder value (Asset4 Mnemonic ENVSCORE).
Social performance	The social pillar measures a company's capacity to generate trust and loyalty with its workforce, customers, and society through its use of best management practices. It is a reflection of the company's reputation and the health of its license to operate, which are key factors in determining its ability to generate long-term shareholder value (Asset4 Mnemonic SOCSCORE).
Governance performance	The corporate governance pillar measures a company's systems and processes, which ensure that its board members and executives act in the best interests of its long-term shareholders. It reflects a company's capacity, through its use of best management practices, to direct and control its rights and responsibilities through the creation of incentives, as well as checks and balances in order to generate long-term shareholder value (Asset4 Mnemonic CGVSCORE).
Integrated strategy & management	The overall level of internal integration measures a company's management commitment and effectiveness toward the creation of an overarching vision and strategy integrating financial and non-financial aspects. It reflects a company's capacity to convincingly show and communicate that it integrates the ESG dimensions into its day-to-day decision-making processes (Asset4 Mnemonic OIL).

Main findings and their implications for practice

Our research suggests that compared to non-adopters,<IR>adopters are more likely to embrace Integrated Thinking by linking CEO compensation to non-financial targets and to the ability to create long term value. They also achieve superior Integrated Performance and better ESG results.

1. Integrated Reporting and Integrated Thinking

- **<IR> and sustainability linked compensation**
  - Compared to non-adopters, <IR> adopters put more emphasis on environmental related targets, as well as on human-type targets and social targets in defining both short- and the medium/long-term objectives for their CEOs.
  - <IR> adopters are also very sensitive to long-term non-financial performance and underscore their attention to their firms' long-term sustainability by linking CEO compensation to medium/long-term non-financial targets (almost 40% of the firms do this).
  - The most common non-financial targets for CEOs at <IR> adopters are human-type targets (87%), followed by social-type targets (31%), intellectual-type targets (26%), and natural-type targets (18%).

- 92% of <IR> adopters link CEO compensation to at least one non-financial ESG target.
- 92% of <IR> adopters have at least one ESG target in the CEO's short-term compensation package.
- 39% have both short- and medium/long-term ESG targets in CEO compensation.

- <IR> adopters typically link CEO compensation to:
  - Human capital targets
    - Examples include: 'employees' well-being', including 'equality', 'rights', 'health', 'safety', 'engagement', 'development', 'satisfaction', and company's 'talent pool management'.
  - Social and relationship capital targets
    - Examples include 'customer relations', 'stakeholder relations' and more generally 'societal objectives'.
  - Intellectual capital targets
    - Examples include product related aspects such as 'quality', 'innovation', and 'productivity'.
  - Natural capital targets
    - Examples include the 'environmental target', 'resource' and 'energy consumption', and 'waste and gas emissions'.

- **<IR> and integrated strategy and management**
  - Compared to <IR> non-adopters, <IR> adopters have a significantly higher level of overall integrated strategy and management as measured by Thomson Reuters Asset4 score "Overall Integration Level" (cf. OIL (Maniora 2017)). More specifically, they have better Thomson Reuters Asset4 scores in the following aspects:
    - significantly better policies for maintaining an overarching vision and strategy that integrate financial and non-financial aspects of the business (cf. "POLICY" Maniora (2017));
    - greater awareness of challenges and opportunities linked to the integration of financial and non-financial issues (cf. "CHALLOP" Maniora (2017));
    - more transparency and comprehensible implementation of integrated firm strategy in the business model through the process description of a public comment or the establishment of a sustainability committee or team (cf. "VOLUNTARY" Maniora (2017));
    - more appropriate communication tools (whistle blower, ombudsman, suggestion box, hotline, newsletter, website, etc.) to improve general business ethics (cf. "(COMMUN)" Maniora (2017));
    - better self-monitoring for its integrated strategy by belonging to a specific sustainability index or conducting external audits (cf. "MONITOR" Maniora (2017));
    - a better company stakeholder engagement policy (cf. "ENGAGE" Maniora (2017));

2. Integrated Reporting and performance

- **Compared to non-adopters, <IR> adopters have better non-financial performance, measured through environmental, social, and governance (ESG) scores.**
  - In particular, they have better non-financial performance in general, and, with specific reference to three aspects, environmental, social, and governance performance.
- **Compared to non-adopters, <IR> adopters have better Integrated Performance, namely, better combined financial and non-financial performance.**
  - Integrated Performance, indeed, is an equal-weighted rating estimated by Thomson Reuter Asset4 analysts and widely used to evaluate corporate sustainability. Thomson Reuter Asset4 is the world's leading provider of ESG information.
- **The relationship between <IR> and economic performance remains trivial.**
  - Although compared to <IR> adopters, non-<IR> adopters have better scores with reference to the economic pillar (as measured by Thomson Reuters's analysts) and Tobin's Q, no significant differences between <IR> non-<IR> adopters come to light when looking at more traditional performance measures (e.g. return on equity, return on assets).

3. Integrated Reporting and transparency

- <IR> has become the preferred vehicle to disclose compensation policies for <IR> adopters (70% of the (<IR> adopters disclose CEO compensation information through their <IR>).
- <IR> adopters disclose detailed information about their compensation policies and the extent to which 'value creation' is embedded in remuneration policy (91% of <IR> adopters provide information on the link between CEO remuneration and at least one capital).
- Compared to non <IR> adopters, <IR> adopters report more information on the link between CEO compensation and the different capitals (<IR> adopters on average link CEO compensation to 3 capitals vs 2 capitals for non <IR> adopters).

Implications for managers

- <IR> is associated with Integrated Thinking as it is linked to compensation structures that include both financial and non-financial incentives and, more generally, to integrated strategy and management focused on long-term sustainability.
- <IR> is linked with Integrated Performance as compared to non-adopters, <IR> adopters exhibit better combined financial and non-financial performance.
- <IR> leads to transparency around executive compensation and incentives as <IR> adopters tend to disclose detailed information about how they design their CEO compensation packages and the link between remuneration and value creation by mean of the different capitals in their IR.
- <IR> adoption and CEO compensation packages are powerful tools to ensure that all the factors that are relevant to value creation are integrated into day-to-day decisions and processes (including all the capitals – financial, human, intellectual etc.) and to promote a longer-term view of value which should lead organisations to embed sustainable value creation more clearly into their strategy and business model.

Overall, <IR> preparers who are seeking to take the 'next steps' in their reporting journey and investors/providers of financial capital who wish to understand how remuneration and compensation policies are consistent with and supportive of the overall strategy of the organisation may find such research useful.

However, due to the relatively, small to medium sized businesses, our conclusions would not of necessity apply to large listed multi-national companies. Furthermore, country specific regulation on compensation disclosure may affect our results.

Conclusion

Our study examined a matched sample of <IR> adopters and non-adopters to shed light on whether <IR>adoption is associated with Integrated Thinking and Integrated Performance. Our findings show the potential of<IR>to increase Integrated Thinking, to lead to superior Integrated Performance and foster transparency in remuneration. It thus illustrates how embracing <IR> and the Integrated Thinking that underpins it can contribute to long term organisational success.

- Compared to non-adopters, <IR> adopters have embraced Integrated Thinking more fully as they incorporate ESG dimensions into their strategies and their day-to-day decision-making processes by defining a more balanced set of objectives for their executives.
- In particular, <IR> adopters are more likely to tie CEO compensation to medium/long-term targets and non-financial objectives, signalling their attention toward Integrated Thinking and long-term financial and non-financial performance.
- Moreover, <IR> adopters outperform non-adopters in terms of Integrated Performance (measured by economic and ESG scores) suggesting that ESG-based incentives are effective in achieving better 'integrated' results.
- Finally, <IR> adopters are more transparent about their incentives and remuneration policies and for them, <IR> has become the preferred vehicle to disclose such compensation policies.

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Authors

Gaia Melloni

Lecturer in Accounting
University of East Anglia,
Norwich Business School
Norwich Research Park,
Norwich,
United Kingdom
NR4 7TJ

T +44 (0) 1603 592553
E g.melloni@uea.ac.uk

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