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Integrated Reporting: Current Trends in Financial Reporting

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Abstract

Corporate financial reporting has rapidly evolved because of stakeholders' increasing demands for transparent and non-financial information. Integrated reporting (IR), which merges financial and non-financial information in reporting and promotes integrated thinking, is increasingly used to meet such demand. The objective of this article is to analyze and synthesize the existing research, examines the current trends in research, and provides some issues for future research.

Keywords IR; IIRC framework; Firm performance; Voluntary disclosure theory; Legitimacy theory

Introduction

Recently, corporate reporting has been challenged due to emerging business risks, regulatory burdens, demand for effective corporate governance practices, and calls for transparency. Integrated reporting (IR) involves 'integrated thinking'. This reporting system incorporates conventional financial accounting with firm's sustainability and corporate governance related issues in order to increase the decision usefulness of business reporting [1]. and posited that one main reason is that as stakeholders needs change and evolve, a demand for diverse set of information intensifies, which in turn, forces companies to rethink their external reporting practices [2]. IR is a new mode to report organization's strategy, governance, performance metrics and the consequent value creation in short, medium and long run. The International Integrated Reporting Council (IIRC) issued the framework in 2013 and since then leading organizations have started preparing IR and their best practices are used for knowledge sharing. Such a report fully combines a company's financial and non-financial performance and is expected to blur the demarcations that exist between financial and non-financial disclosures. The purpose of article is to provide an assessment of the contemporary trend of research on IR as a new mode of financial reporting and also to suggest directions for future research.

IIRC's IR Framework

The IIRC's framework contains three major concepts and the reporting framework focuses on value creation, process of value creating value, and six various types of capitals. IR is a step forward from sustainability reporting. IIRC framework (2013) states:

"An integrated report is 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".

The elements of IR framework are presented in the following Figure 1.

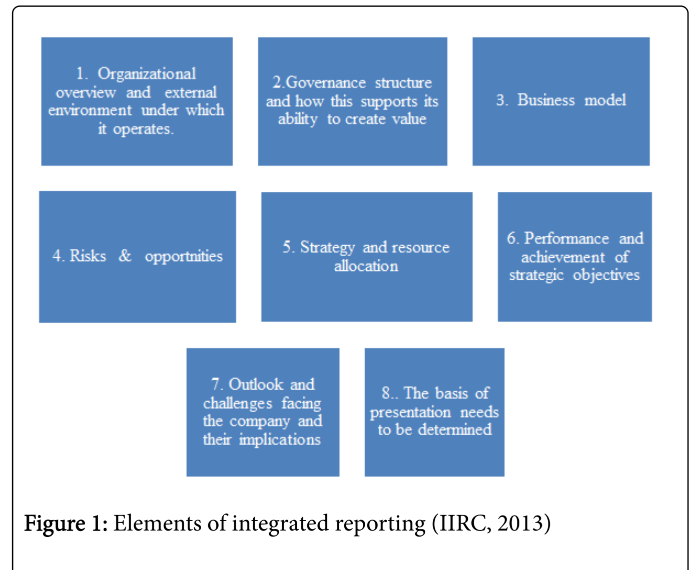

Figure 1: Elements of integrated reporting (IIRC, 2013)

Furthermore, while drafting the IR, KPMG (2012) presented seven guiding principles that should be considered in IR, namely, "strategic focus and future orientation, connectivity of information, stakeholders' relationships, materiality, consciousness, reliability, completeness, consistency and comparability."

Boonlua and Phankasem argued that an overview of organization and external environment forces that provide information on organization performance under different circumstances should be the part of content elements [3]. The report should also explain about the firm's business model, the risks and opportunities that are available to it [4]. Additionally, how the organization is prepared to tackle the exposed risk should be a part of the content elements.

Applicable Theories to IR

Since the implementation of IR is still voluntary in many domains, therefore, one may expect that the scope and quality will vary among the firms. In order to support IR disclosures, Voluntary Disclosure Theory (VDT) may be applied. It means that the firm may select to disclose only information that is considered relevant and useful to the

stakeholders, which actually represents the good faith of companies' activities [5].

Guidry and Patten state that the origin of VDT is from financial accounting and it is used by companies to disclose relevant information to investors for their decision making model [6]. The theory provides the theoretical base for the efforts taken by management to reduce information asymmetry. Balakrishnan et al posited that in order to provide more information than required by laws, management might use voluntary disclosure which is prompted by the clear aim of minimizing information asymmetry between them and the investors [7]. Furthermore, it is argued that information asymmetry between managers and owners cause most of the agency conflict. In this context, Lobo and Zhou stated that to mitigate the information asymmetry problem, the firm need to disclose non-financial information which creates alignment of interests between managers, owners, and minority interests [8]. Through increased disclosure, a firm may increase its value and may meet the expectations of the owners. Therefore, agency theory is also applicable to IR research.

Furthermore, it is also posited that being a good corporate citizen, IR increases a firm's goodwill and reputation, therefore, legitimacy and institutional theories are also relevant in IR context. Dagan [9] agrues.

"Legitimacy theory suggests that IR primarily serves to legitimize an organization's activities".

Jensen and Berg emphasized the added value of the integrated reports compared to other forms of communication [10]. As per institutional theory, companies have to function under socio-political, cultural, and economic environment in which the institutions often put pressure and constraints on the way they run their businesses. Companies have to comply with institutional requirements for continuing their operations and when companies adopt IR, they have an added impetus to comply with such requirements.

IR represents a reconciliation of shareholder theory and stakeholder theory [11]. According to shareholder theory, the main aim of an organization should be to enhance shareholders' value. The role of IR is to report on environmental, social, and governance performance of the firm. Similarly, creating value for all the stakeholders is the objective of stakeholder's theory. To achieve this, stakeholder's theory incorporates environmental, social and governance issues. By adopting and implementing IR, firms become more aware of their stakeholders, who might influence the decision-making process [11].

Literature Review

Ioanaa and Tiron-Tudor state that the diffusion and adoption of IR is expanding [12]. It means that there is an increasing trend in the awareness of IR research [13], however; the contemporary state of IR research output is not well analyzed and synthesized. Some studies [14-18] have focused on reasons for IR, awareness, reported benefits, challenges, adoption rate of IR, and impact on profitability. Furthermore, IR implementation is also influenced by size and profitability [19].

Researchers have also attempted to examine disclosure aspects of corporate governance and non-financial information in annual reports of companies and banks [20-24]. One of the claims of the benefits of the IR is that it helps the long term investors to improve their decision-making. However, Rensburg and Botha, in South African cortex, examined the type of information used by various stakeholders and reported that IR did not contribute significantly to investors decision-making process.

Recently, few researchers have used content analysis and examined the relationships between the financial performance (return on equity and return on assets) and degree of disclosures of various elements of IR framework from annual reports using panal data. Barin and Ansari reported insignificant relationship between level of disclosure for environmental and social information and ROA. The same was the case for ROE as well [25]. However, the sample size was limited and the panel data was only for two years. Albetairi et al. reported significant differences in IR compliance in Bahrain with respect to listed insurance companies [24]. Furthermore, they found positive and significant relationship between ROA and resource allocation, strategy, and business model. However, risk opportunities and performance elements had a negative and significant relationship with ROA. A few other studies also reported an improvement in financial performance of companies with IR implementation [24]. The compliance and control roles also improve the financial performance. Wen et al. reported in Malaysian context that among the eight content elements of IR, four of them, namely risks and opportunities, business model, performance disclosure, and governance have significant positive impact in improving the financial performance of the companies [5]. Similarly, Barth et al. reported a positive association between variances in the quality of integrated reports and firm financial performance [26].

Under mandatory implementation of IR, Dube examined the relationship between IR and financial performance of firms on the Johannesburg Stock Exchange [27]. The study found no relationships between the differences in the quality of integrated reports and share returns. While, Zhou et al. reported a positive impact of differences in quality of integrated reports on capital market [28].

Direction for Future Research

The future research may be focused on cross cultural comparisons of IR adoption and its impact on value creation. There is very limited evidence on the influence of culture on IR implementation. It appears that Garcia-Sánchez et al. work is the only research done till to date [29]. It may be of interest to investigate in future studies the four cultural aspects as proposed by Hofstede [30].

Research focusing on capital market reactions to IR is an important area for future research. More analysis is needed on the firm characteristics and determinant variables in the implementation of IR, its quality and quality of management, and market reactions to such adoption. Additionally, how the display of intellectual capital and other forms of capital in IR contribute to the value creation in longer periods needs to be explored. Melloni reported that there is a positive effect on firm size, performance, and intangibles when the information on intellectual capital is provided through IR [31]. Since this is an important area of research, it needs further empirical investigation. IR quality and e.g., accuracy of analysts' forecast and firm valuation are other emerging topics for future research. Lee & Yeo reported positive a relationship between IR quality and Tobin's Q, however, this area needs comprehensive investigation to get clear empirical support [32].

Does the implementation of IR affect the cost of capital of the firm? This area needs empirical support by examining the type of relationship between cost of capital and IR disclosure. Longitudinal studies may be required because IR should decrease the firm's cost of

debt and equity over a time period. Carvalho and provided limited evidence in this area [33].

Furthermore, Haji and Anifowse posited that some firms prepare integrated reports with the purpose of gaining legitimacy [34]. This claim needs to be tested in future studies particularly in those environments which have poor corporate social responsibilities performance.

Controlling variables such as ownership, corporate governance factors, age of the company, emerging information technologies may also be included to test how firm performance is reflected with the implementation of IR. Additionally, an important area for investigation is how to encourage auditors to use innovative ways to deal with the issue of being unable or unwilling to form an opinion on forward looking information [35].

Furthermore, investor's opinions of the IR need also to be examined in details. In this context, Dube suggests to investigate investors' opinion about the information contained in these report and which information they consider to be incrementally valuable for their decision model [27].

Last but not the least, it looks that the measurement of IR quality is also questionable. IR framework needs to be standardized IIRC needs to think of introducing a checklist for measuring IR quality [36-38].

Concluding Remarks

IR is an emerging area as a new paradigm in financial reporting as it is receiving tremendous acceptability in business practice and has recently gained an emerging area for the empirical research. Surveys have reported that awareness among companies' accountants and executives on IR has increased. Now, there is a tendency to report more on non-financial information and it will likely to continue in future. A few research studies have shown that implementation of IR by companies improves the financial performance of companies.

The future research needs to shed light whether investors and other stakeholders decision-making quality is improving under IR. Can researchers suggest alternative method of extracting information from IR reports instead of depending on content analysis alone? One of the limitations of content analysis research is the element of subjectivity and possible bias which sometimes affect validity of the research findings. Finally, there is a greater need for a robust evidence of the impact of implementation of IR framework on the value creation in term of profitability (short term), growth in sales (medium term), and market returns to shareholders or reflect a value premium (long term). Future studies should also assess the impact on firm performance of IR by including Tobin's Q in addition to ROA and ROE.

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