The economic consequences associated with integrated report quality: Capital market and real effects

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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. We 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, we 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, we find a positive association between IRQ and liquidity, which supports the capital market channel. We find no evidence of a relation between IRQ and cost of capital. We also find a positive association between IRQ and expected future cash flows. Because this association could reflect better investor cash flow forecasts—a capital market effect, better internal decisions—a real effect, or both, we attempt to distinguish these explanations. We find higher IRQ is (not) associated with higher realized 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, our findings are consistent with integrated reporting achieving its dual objective of improved external information and better internal decisions.

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1. Introduction

The question we address is how integrated report quality, IRQ, is associated with firm value. In particular, we identify two channels through which IRQ may be associated with firm value—a capital market channel that relates to improved information for outside providers of capital and a real effects channel that relates to improved internal decision making. Our motivation for focusing on these effects is that the International Integrated Reporting Council’s (IIRC) Framework identifies two aims for integrated reporting: (1) improving the quality of information available to outside providers of financial capital to enable more efficient capital allocation and (2) supporting integrated internal thinking, decision-making, and actions that focus on value creation for the firm. Thus, in contrast to accounting standards or other types of disclosure regulation, e.g., the U.S. Securities and Exchange Commission’s (SEC) Form 10-K, integrated reporting has the dual objective of providing information to external and internal decision makers. We empirically evaluate the extent to which, and how, integrated reporting achieves this dual objective.

Since the release of the IIRC Framework in 2013, worldwide interest in integrated reporting continues to grow. According to the IIRC, more than 1500 firms currently prepare an integrated report, including AES Brasil, Clorox, GE, Mitsubishi, Novo Nordisk, Tata Steel, and Vivendi. There also has been strong support for integrated reporting from the large accounting firms as well as standard-setters and professional accounting bodies in various countries. Among regulators, the IIRC Framework recently was endorsed by China’s Ministry of Finance, and the Securities and Exchange Board of India (SEBI) is encouraging the top 500 listed firms in India to adopt voluntarily integrated reporting starting with the 2017–2018 financial year. Further, the IIRC has started to engage with other standard-setters, including the International Accounting Standards Board (IASB) and the U.S. Financial Accounting Standards Board (FASB), as part of the Corporate Reporting Dialogue to consider alternative disclosure models, and Richard Howitt, the IIRC Chief Executive Officer, has identified 2018 as the start of a “global
... targets price forecast accuracy is higher for firms with higher IRQ, which would support the capital market interpretation, and whether realized future operating cash flow is higher for firms with higher IRQ, which would support the real effect interpretation of the relation between IRQ and expected future cash flow. We provide additional evidence on the real effect channel by determining whether IRQ is associated with firms’ investment efficiency by examining a specific type of internal decision, i.e., investment decisions. Our study contributes to the literature and practice in several ways. First, we add to the limited empirical research on integrated reporting by extending Lee and Yeo (2016) and Zhou, Simnett, and Green (2017), which also focus on South African firms. Whereas Lee and Yeo (2016) examine whether IRQ is associated with firm value, we investigate the channels by which this association occurs. Whereas Zhou et al. (2017) investigate two capital market effects of integrated reports, i.e., analyst forecast properties and cost of capital, they do not link these effects to firm value and do not consider real effects, which we do. Second, we answer Leuz and Wysocki’s (2016, p. 530) call for research on disclosure in “novel settings” in countries outside the U.S. and to examine “nontraditional disclosure” and “the real effects of disclosure mandates.” Third, we extend the literature on implications of extra-financial information (Dhaliwal, Li, Tsang, & Yang, 2011; Dhaliwal, Radhakrishnan, Tsang, & Yang, 2012; Lu, Shailer, & Yu, 2017; Plumlee, Brown, Hayes, & Marshall, 2015). The relations we document include controls for the issuance of a standalone CSR report as well as accounting quality and overall disclosure quality. Thus, our evidence shows that integrated reports are associated with benefits incremental to those associated with existing reports, such as standalone CSR reports. Fourth, we provide evidence for managers, practitioners, standard-setters, regulators, and investors as they evaluate the merits of integrated reporting. For example, the SEC issued a Concept Release on proposed changes to business and financial disclosures required by Regulation S-K and asked, “How important to investors is integrated reporting, as opposed to separate financial...
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