Integrated Reporting, Corporate Governance, and the Future of the Accounting Function

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Abstract

The marketplace is continuously evolving, and it is imperative for financial professionals to understand these trends and to be able to integrated these trends into business decision making. Corporate governance and stakeholder theory are increasingly important trends influencing both academic research and practitioner actions, and this increasing influence has generated two theories of particular importance to financial professionals. Integrated financial reporting, or integrated reporting, represents the culmination of several disparate trends in non-traditional reporting. Supported by the International Integrated Reporting Council (IIRC), this initiative requires accounting and financial professionals to think more holistically about financial performance. Strategic management accounting (SMA) represents this comprehensive view of financial performance that financial professionals must embrace to move forward with an increasingly complex business environment.

Keywords: Corporate Governance, Integrated Reporting, Strategic Management Accounting, Finance, Stakeholder, Stakeholder Theory

Introduction

Corporate governance is an issue that is generating headlines and debates in both practitioner and academic circles. Up for debate are the mechanics of governance, the interaction between the Board (which normally implements governance), and corporate strategy, and how governance is integrated with business operations. Acknowledging different points of view about this topic leaves one area beyond dispute, which is that governance effects business decision making. The management of Alibaba stands poised to undertake possibly the largest IPO in U.S. history, but has been delayed several times due to issues regarding disclosure and governance. Accounting issues also pay a critical role in the business decisions making, and the integration of technology and non-traditional measures into financial reporting has created the integrated reporting framework. Led by the International Integrated Reporting Council (IIRC), with support from both institutional and regulatory partners, this framework represents the forefront of accounting innovation. Integrating traditional financial information with non-traditional, stakeholder-oriented information is a critical step toward a comprehensive view of financial performance. These three pillars, stakeholder engagement, corporate governance, and integrated financial reporting, are revolutionizing both how organizations manage internal operations, but also how organizations interact with both internal and external stakeholders. Together, these trends represent a fundamental shift in how business is done, how it is reported, and how organizations interact with the environments within which they operate. Culminating in an integrated financial report, these mega-trends will potentially redefine the role of financial professionals for the foreseeable future.

Corporate Governance

Corporate governance is, in essence, how the management team (led by the Board of Directors) runs and manages business operations. Dealing with shareholders, managing executive compensation, and launching strategic initiatives are simply a few of the structural responsibilities of a business that are linked to corporate governance.

Traditionally relegated exclusively to Board members, and not more broadly discussed, corporate governance topics appeared less frequently in headlines and attracted less attention. Governance, following the financial scandals of the late 1990s and early 2000s, become increasingly regimented and structured, which led to a largely check-the-box mindset related to governance initiatives. Following the financial crisis, this is changing, and both the management teams themselves as well as external regulators understand the growing linkage between governance and financial performance. Governance, in practice, varies widely from nation to nation. Western European nations are known for inclusive Boards that include members of workers' unions and other non-shareholder entities. In Eastern Asia, such as Japan, South Korea, and China, national and local governments maintain strong presences on both Boards and in senior management roles within organizations. In the United States, and in contrast to other arrangements around the world, almost exclusively either financial shareholders, or proxies of large institutional shareholders, implement governance initiatives and strategies. In light of increasing scrutiny and debate regarding corporate malfeasance, as well as the effect that organizations have on the environment in which they operate, many businesses are shifting toward a more holistic view of governance.

Governance and Business

Upon closer examination, it is clear that corporate governance exerts substantial influence over business operations, policies, and procedures. Strong and cohesive governance practices have been linked to the IPO market, reminiscent of the debate and conversation regarding Alibaba. Organizations associated with strong and cohesive corporate governance, over a ten year period concluding in 2006, commanded a price premium when compared with organizations without strong corporate governance infrastructure (Bell, Filatotchev, and Aguilera (2014). While effective governance policies and procedures were not the only factor in determining the market premium pricing, the fact remains that a quantitative link exists between governance and IPO pricing. Price premiums and superior financial performance are of interest to both internal and external stakeholders, as virtually all participants benefit from improved pricing and transparency. Governance, via structures embedded with the policies and procedures necessary to develop and implement comprehensive governance polices, also establishes an effective linkage for other initiatives. Linking strategic planning theories such as human capital development and sustainability lend Board- level support and structure to said initiatives (Young & Thyil, 2014). Governance provides direct benefits to the organization via improved transparency and improved pricing and provides a framework for other initiatives to build upon. These examples illustrate a clear and quantifiable linkage between governance and financial performance, but the connections extend even further.

Feeling pressure from both external and internal stakeholders, many organizations are adopting CSR initiatives, charitable giving, and other sustainability-related strategies. A concern that arises, which relates to governance, is that undertaking such initiatives may place the management team at risk of allegations related to fiduciary duty. The development of flexible purpose organizations, most notably b-corporations, is a clear linkage of corporate governance and stakeholder theory (Hiller, 2013). Admittedly, while many of these alternatively structured corporations are smaller in size, large organizations such as Ben & Jerry's are household names, with a global footprint, that have successfully integrated good governance (via listening to stakeholders) to successful financial performance. Particularly in the business environment following the financial crisis of 2007-2008, governance is playing an increasingly large role in business decision-making (Fulop, 2014). From the academic evidence as well as growing discussion and coverage of governance topics, including the founding of GMI ratings, which rank companies based on governance metrics), it appears that governance clearly has a growing role in the business environment.

Stakeholder Theory

Stakeholder theory focuses on the need for businesses to report adequate information to meet the needs of all stakeholder groups that include, but are not limited to, financial shareholders. The implications of this paradigm shift affect both corporate reporting and the internal mechanisms required to create and deliver this information to end users, specifically the internal accounting and finance functions (Ratnatunga & Alam, 2011). An example of a U.S. based organization that has embraced a stakeholder-oriented approach to financial reporting and decision making is American Electric Power (AEP). Integrating the needs of regulators, environmental groups, and shareholders has allowed the company to create reporting tools that deliver the information needed by these different groups and to improve working relations (Parrot & Tierney, 2012).

Information demanded by regulators, partners, and suppliers is different than that requested by financial shareholders, so it is imperative for managerial teams to understand how stakeholder theory links together internal and external operations. Developing and distributing the wide varieties of information required by different stakeholder groups is a critical step in enhancing transparency and improving stakeholder relationships. The evidence presented here, as well practitioner debate and conversation regarding the importance of engaging, and working with, stakeholder groups, is a clear illustration of the importance of stakeholder theory, and the linkage this theory provides decision makers.

Robert Eccles, of Harvard Business School, is both a subject matter expert on stakeholder theory and integrated reporting, and a proponent of standardization for non-traditional reporting metrics. Auditing, attestation, and other advisory services, which form the cornerstones of the AICPA, IMA, ACCA, and CIMA member offerings, are dependent on standards with which to evaluate and compare business results. Developing and implementing standardized metrics, and even sector-specific evaluative tools in an integral step in legitimizing non-traditional, stakeholder-oriented reporting (Eccles, Krzus, Rogers, and Serafeim, 2012). Organizations must be able to meet the demands of non-financial stakeholders in order to satisfy regulatory reporting requirements as well as maintaining leadership positions in the marketplace (Dawkins, 2014). Decision makers that integrate stakeholder demands, requests, and needs into the financial decision making, and reporting, process, appear to be poised to lead the marketplace going forward. The market punishes organizations that are not transparent, open, and forthcoming with both positive and negative news, and organizations that embrace the strengths and opportunities presented by communicating with external stakeholders will benefit.

Stakeholder Theory and Financial Performance

Stakeholder theory emphasizes a more comprehensive view of financial performance, which can also be interpreted as a longer-term managerial orientation. Conscious capitalism and intangible assets are areas where longer-term orientation and focus on financial performance generate superior returns for financial shareholders (Simpson, Fischer, & Rhode, 2013; Mustata, Matis, & Bonaci, 2012). As intangible assets such as brand equity, intellectual property, and intellectual capital generally increase as an overall percentage of marketplace value, the importance of these will continue to increase. Linking stakeholder theory and action to intangible assets and conscious capitalism is relatively straightforward. Conscious capitalism integrates a longer-term (5, 10, or 15-year) managerial philosophy to business decision making. Organizations identified as using conscious capitalism generated returns of 83.4% over the 15-year period ending in 2014, versus a return of 47% for S&P 500 as a whole (Simpson et al., 2013). From this evidence, it is clear that management teams who can successfully integrate longer-term orientation and incorporate non-traditional metrics generate positive financial results for shareholders. Bridging this gap of competence and standardization still remains a significant challenge, and financial professionals are well-positioned to assume leadership roles in this new arena. Integrated financial reporting, or integrated reporting, appears to present the cohesive framework that both practitioners and researchers can utilize toward these goals.

Integrated Financial Reporting

Integrated reporting appears to represent a culmination of several disparate threads poised to reshape how business operates and interacts with the external environment. Traditional financial reporting focuses on exclusively on backward-looking financial information developed and prepared for debt and equity holders. In a rapidly evolving marketplace, which is incorporating increasing elements of sustainability, stakeholder requirements, and intangible assets, such a reporting template is inadequate. Linking SMA and integrated reporting is relatively straightforward, and in order to produce and distribute more nimble, real time and actionable information for marketplace participants, the internal accounting function must evolve and develop. A growing subset of academic research supports this growing trend in financial reporting, and marketplace realities (including increasing pressure from stakeholders) further illustrate the importance of this reporting methodology.

Integrated Reporting in the Marketplace

Integrated reporting, spearheaded by the International Integrated Reporting Council (IIRC), is a template for a new type of financial reporting. Summarizing the underlying motivations behind the creation of the integrated reporting template is essential to explaining the value proposition to potential users (Abeyeskera, 2013).

The development of such non-traditional methodologies allows both individuals and organizations to leverage the quantitative strengths of finance and accounting personnel to integrate non-traditional information into financial statements (Smith, 2014). An integrated financial report should be able to explain the mission and purpose of an organization, outline the governance and monitoring methods used to ensure compliance with this mission, and demonstrate the ability of an organization to quantify the impact of the measures on the financial performance of the organization.

It is also imperative to understand the ability of integrated reporting to link together various threads of non-traditional accounting and financial information to develop a comprehensive view of financial performance. Sustainability reporting and sustainability officers are present at an increasing number of corporations. According to research by Berndt, Bilolo, and Muller (2014), organizations clearly link integrated reporting to financial performance, and organizations that use a fully integrated report score 30% higher than organizations that do not. Another real world example of the growing importance of integrated reported is the Johannesburg stock exchange where, beginning in 2010, all organizations listed on the exchange were mandated to issue financial statements utilizing an integrated reporting template. Examples of multinationals using a version of the integrated reporting template include Pfizer, Dow Chemical, Ingersoll Rand, Novo Nordisk, Eni, and Unilever. Such widespread international support is only likely to increase with the continued support of the IIRC and participating partners organizations.

The concept of integrated reporting focuses on several key pillars. First, the concept of integrated reporting is rooted in the fact that the business environment has continued to evolve, and that in order to stay relevant, organizations must evolve along with it. Second, non-financial stakeholder groups, such as the ones mentioned above, demand more quantitative and comprehensive information as it relates to financial performance. Third, in order to deliver meaningful information to both financial and non-financial stakeholders, organizations must be able to understand and quantify the information that is being requested of them. The development of metrics and indices related to sustainability metrics and integrated reporting supports a more integrated approach to financial performance and is a clear demonstration of increasing market support for these initiatives (Wagenhals, Garner, Duckers, & Kuhn, 2014). These key pillars of this reporting trend, and the critical gap that presently exists in the literature between the theoretical frameworks proposed versus real world implementation of the integrated format, are critical issues for the profession (Ioana & Adriana, 2012). The comprehensive development of an integrated framework requires a new mindset on how to create, report, and sustain value in the financial reporting process (Tilley, 2014). A more comprehensive view of financial performance, and the necessary components of an integrated financial report, combine several areas, including sustainability, governance, and stakeholder theory, and are combined by a strategic accounting function. A convergence of this magnitude, bringing together professionals and schools of thought previously only marginally associated, demonstrates the importance of this trend.

From the evidence presented above, and the wide range of practitioner research and discussion concerning the issues of non-traditional reporting, it appears that the financial landscape is undergoing a dramatic shift. As stakeholders, including regulators, demand more real-time and actionable information from businesses, organizations must evolve and adapt to fulfill these new requirements. Stakeholder theory provides the academic framework in which a new reporting framework can evolve, and the accounting function provides the necessary quantitative skills to implement such a framework. These trends, and the effect they have on organizations both internally and externally, appear to be poised to radically reshape the field of corporate accounting and finance.

The Future of Finance

The finance profession is undergoing a disruption and changes that are redefining the role that finance and financial professionals occupy in managerial decision making. Stakeholder theory, embracing the needs of a wide variety of stakeholders, is moving from mere theoretical conjecture to real world implementation. Examples such as Boeing, leveraging stakeholder valuing, are clear demonstrations of the importance and viability of stakeholder applications to financial reporting. Integrated financial reporting, considered by many to be the culmination of non-traditional reporting metrics, is growing in terms of usage and institutional support. The Johannesburg stock exchange is an excellent example of the real world implications of a strategic accounting function.

Financial professionals provide the information necessary for financial decisions, so the linkage between stakeholder theory, integrated reporting, and a strategic management accounting function appears to be a critical component in non-traditional financial reporting. Leveraging internal capabilities and acknowledging the increasingly important role of stakeholders in business decision making, the linkage between stakeholder theory and financial services professionals becomes clearer. Building on this connection, integrated financial reporting appears well positioned to fill this need for both academic researchers and industry practitioners. Stakeholder, and financial shareholders, benefit from a more comprehensive view of financial performance, and the financial services industry is positioned to benefit from this paradigm shift.

Conclusion

In a rapidly changing and evolving global marketplace, it is imperative for the management of organizations to keep abreast of changes effecting both specific industries and the marketplace overall. Following the global financial crisis, subsequent prolonged economic sluggishness, and highlighted by recent high-publicity events such as debates surrounding the Alibaba IPO, corporate governance is clearly a trend worth monitoring. Accounting, and the financial services profession in general, is undergoing a radical transformation. Integrating advances in technology and balancing increases in marketplace demands for real-time information have resulted in an entirely new lens through which financial services operate. Business decisions require accurate, relevant, and timely information, and the accounting function is the functional business unit that delivers this information to managerial decision makers. Linking governance, which is how a management team runs the affairs of an organization, to internally-created and verified information is an important step to both improve the quality of governance decision making and leverage internal accounting capabilities. This transformation of both the marketplace and marketplace expectations contains an academic underpinning in addition to practitioner-oriented drivers. Stakeholder theory and the resulting increases in stakeholder engagement are driving a new type of financial reporting in the form of an integrated reporting template. Linking together governance, stakeholder requirements, other non-traditional demands, and integrated reporting requires real-time, flexible information. These three pillars, linked together by both market demand and synergistic connections, appear to be have a very significant impact on the way businesses operate and report results to market participants.

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