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Executive Summary

Building Trust through transparency: The Economic Impact of Extended External Reporting (EER)



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We recognise and pay respect to the Elders and communities – past, present, and emerging – of the lands that the University of Sydney's campuses stand on. For thousands of years they have shared and exchanged knowledges across innumerable generations for the benefit of all.

Building Trust through transparency: The Economic Impact of Extended External Reporting (EER)

Key conclusions

Utilizing the UK's shift in corporate reporting regulatory regime from the Enhanced Business Review (EBR) (2007 to 2012) to Strategic Reporting (SR) (2013 to 2018), we find that firms producing high quality strategic reports enjoy significant capital market benefits including higher liquidity, higher market value, lower cost of capital, and more accurate and less dispersed analysts' forecasts. These benefits are, however, only significant during the post-SR period. This suggests that SR as a new form of EER that is highly aligned with Integrated Reporting, allows firms to more effectively communicate to capital markets, which in turn affects capital market participants' resource allocation and information processing.

In a comparative study examining the Operating and Financial Review (OFR) produced by Australian listed companies during 2015-2018, we find limited evidence that companies producing high quality Operating and Financial Review (OFR) derive significant capital market benefits in terms of having less dispersed analysts' forecasts. But we do not find significant evidence of other capital market outcomes.

The OFR shares similar characteristics with the pre-SR regime in the UK, i.e. the EBR regime. The Australian finding is therefore largely consistent with that in the UK, that is, there are fewer capital market effects.

Moreover, by comparing reporting practices between the UK and Australian companies, this study finds that Australian companies have considerable room for improvement towards reporting in line with the latest development in corporate reporting, i.e. Integrated Reporting.

Our study has important policy implications for the development of corporate reporting in Australia. The results suggest that there are benefits in moving towards a broader, more connected and more strategically oriented corporate reporting framework such as SR and IR. These movements are gaining traction in Australia, and these reporting frameworks have recently been acknowledged but, as yet, are not required in preparing the OFR in Australia (ASIC 2017).



Abstract

We perform a comparative study in the UK and in Australia on the economic impact of Extended External Reporting (EER).

In the UK, we utilize the corporate reporting regime shift in the UK from the Enhanced Business Review (EBR) (2007 to 2012) to Strategic Reporting (SR) (2013 to 2018).

While the EBR is similar to those reporting forms currently in operation in other countries, such as the Operating Financial Review (OFR) in Australia and the Management Discussion and Analysis (MD&A) in the U.S., SR represents a new form of corporate reporting that is broadly consistent with the latest development in corporate reporting, i.e. Integrated Reporting (IR).

Using a pre-post research design, we find that during the post SR period, firms that score higher on the quality of their corporate reports enjoy significant capital market benefits. In particular, we observe that environmental, employee, social, community and human rights information (EESCH) and information linkage (LINK) are the two components that consistently contribute significantly to all observed capital market benefits. This suggests that the provision of socially relevant information and well-connected information is valued and 'rewarded' by capital market participants.

Our pre-post design, and the fact that we also observe that capital market benefits are insignificant during the pre-SR period (i.e. the EBR period), provides evidence that SR allows firms to more effectively communicate to capital market, which in turn affects capital market participants' resource allocation and information processing. As a result, high reporting quality firms enjoy increased significant capital market benefits during the post SR period.

When examining the economic impact of the Operating and Financial Review (OFR) in Australia, we do not find significant evidence that companies producing high quality OFR enjoy capital market benefits except for less analysts' forecast dispersion. This result is consistent with that in the UK as the OFR shares similar characteristics with the pre-SR regime in the UK, i.e. the EBR regime. Collectively, the evidence supports the UK's regulatory shift from EBR to SR. The evidence also supports the global move towards a more integrated and strategic form of reporting which considers multiple forms of capital (beyond financial capital) and which better articulates the linkages among various capitals.



Introduction

Organisations globally are increasingly being held to account for a broad range of disclosures beyond traditional financial accounting disclosures, thereby acknowledging their impact on the environment, (e.g., carbon emissions) and society (e.g., social diversity and equality). We term these disclosures Extended External Reporting (EER). Governments, communities, asset managers and institutional investors are driving the call for improved disclosure on these issues using EER.

However, increased reporting is not without its costs, and concerns have been expressed about “compliance fatigue” for providers and information overload for users. There has, therefore, been considerable debate as to how best reporting can be expanded but in an effective manner (see Financial Reporting Council [FRC] 2009, 2020).

Amidst this trend, Integrated Reporting (IR) has emerged and gathered global recognition and momentum as a reporting framework that promises to provide investors with information that will enable more effective capital allocation (FRC 2014; International Integrated Reporting Council [IIRC] 2018; International Accounting Standards Board [IASB] 2018; International Financial Reporting Standards Foundation [IFRS Foundation] 2019, 2020; KPMG 2020). Compared to other forms of reporting (such as the U.S. Securities and Exchange Commission’s (SEC) Form 10-K and ESG/Sustainability/CSR reporting), IR requires reporting on a broader set of capitals – financial, manufactured, intellectual, human, social and natural – and highlights the importance of communication principles, such as connectivity, strategic focus, and future orientation in enabling effective disclosure (IIRC 2013; Barth, Cahan, Chen, and Venter 2017; Zhou, Simnett and Green 2017).

With the availability of several enhanced reporting frameworks that are similar to IR, various regulatory responses have also emerged. The Strategic Reporting (SR) regime in the UK is a leading example of a reporting framework that is highly aligned with IR (Wang et al. 2021). A Strategic Report is a separate section located at the beginning of an Annual Report. It is believed that this prominent position is the first place investors will go to acquire the key information they need (The Department for Business, Innovation and Skills [BIS] 2012). The SR regime replaced the prior Enhanced Business Review (EBR 2007–2012), which is similar to corporate reporting forms currently in operation in other countries, such as the Operating Financial Review (OFR) in Australia and the Management Discussion and Analysis (MD&A) in the U.S. Compared to the EBR, the SR represents a new form of corporate reporting that shares similar qualitative

characteristics and content elements with IR for effective communication such as a strategic focus, effective linkage and a forward-looking emphasis.

In Australia, there are general regulatory requirements for listed entities to disclose associated risks and processes in the Operating and Financial Review (OFR), which supplement the financial report and assist shareholders in understanding the operations, financial position, business strategy and prospects of an entity. In issuing the regulatory guidance for OFR, the Australian Securities & Investments Commission (ASIC) considered and decided not to include any guidance on IR because the concept was emergent (ASIC 2013). Nonetheless, it was indicated that the regulatory guide could be amended in the future to incorporate developments in IR.

In December 2017, ASIC issued a media release calling on companies to focus on giving information for users of financial reports that is useful and meaningful. That release also stated support for Directors to consider disclosing additional information that would be relevant under IR where that information was not already required for the Operating and Financial Review (OFR). The latest edition of the Corporate Governance Principles & Recommendations (2019) from the ASX Corporate Governance Council (2019, R4.3) also suggests companies consider adopting IR principles in annual reports.

Given the similarities with the EBR in the UK and the OFR in Australia, a comparative study will shed light on whether a move towards a broader corporate reporting framework such as IR would be beneficial. Such a study would provide valuable guidance for regulators in Australia in formulating policies on effective corporate disclosure.

Objectives

This study aims to document the economic consequences of the UK’s legislative move from EBR to SR. We take advantage of long time-series data (2007–2018) before and after the move to SR (in 2013) to provide empirical evidence on whether the change in reporting regime to an enhanced form of corporate reporting that is highly aligned with IR has had a significant economic impact.

As a comparative analysis, this study further examines the capital-market effects of the EER practice in Australia using the Operating and Financial Review (OFR). This study aims to inform policy makers in Australia on whether and how best to change the corporate reporting landscape in Australia.

Research method

Sample and data

UK: FTSE350 firms listed on London Stock Exchange from 2007 to 2018. After excluding observations with insufficient financial data for analysis, the largest sample for analysis consists of 2,307 firm year observations with 1,541 observations during the pre-SR period¹.

Australia: Top 100 companies listed on the ASX by market capitalization, as of December 31st each year, from 2015 to 2018. After excluding observations with insufficient financial data for analysis, the largest sample for analysis consists of 254 firm year observations.

Reporting quality measure

UK: We use the data provided by PwC UK to construct the independent variable of interest in the study, i.e. the corporate reporting quality (SRQ), which is a score between 0 and 1 capturing the overall reporting quality for each firm within a certain year. We further decompose the overall SRQ into the following 7 components, including five content elements, i.e. strategy and objectives (SO); business model (BM); principal risks and uncertainties (RISK); analysis of performance and position (PERF); environmental, employee, social, community and human rights matters (EESCH); and two communication principles, i.e. information linkage (LINK) and forward-looking orientation, (FO).

Australia

A self-constructed coding framework was developed from the International <IR> Framework (2013) and the Guidance on the Strategic Report (2014). The coding framework consists of 18 elements across 7 components: strategy and objectives, business model, risks, performance and outcomes, stakeholder relationships, forward-looking orientation/future outlook; information linkage/connectivity. The OFR reports produced by sample companies were scored against 18 elements from zero to one. The proxy for the overall quality of OFR (OFRQ) is the sum of the raw score assigned to OFR reports produced by sample companies, divided by the maximum available score.

Other data

Financial data required to construct dependent variables, i.e. the capital market benefits and control variables are obtained from widely used commercial databases, including the Global Compustat and I/B/E/S from WRDS and Eikon from Thomson Reuters.

Research model

We use well-accepted statistical models for our analysis, i.e., OLS regressions as follows:

UK:

$$EconCon_{i,t} = \beta_0 + \beta_1 Reporting\ Quality_{i,t} + \beta_1 Post + \beta_1 Reporting\ Quality_{i,t} * Post + \sum \beta_j CV_{i,t} + \varepsilon_{i,t}$$

Australia:

$$EconCon_{i,t} = \beta_0 + \beta_1 Reporting\ Quality_{i,t} + \sum \beta_j CV_{i,t} + \varepsilon_{i,t}$$

The dependent variable (EconCon) is measured using stock liquidity, cost of capital, and analysts' forecast error and dispersion. The independent variable of interest is the corporate reporting quality, i.e. SRQ in the UK and OFRQ in Australia as described previously. In the UK, we employ a pre-post design using the variable "Post" to indicate if the sample is pre-SR period, i.e. 2007 to 2012 or post-SR period, i.e. 2013 to 2018.

We include a list of control variables (CV) consistent with prior studies such as firm size, profitability, governance, industry, etc.

We employ multiple specifications of the models to strengthen the causal effect of the relationships. We also perform sensitivity analysis to test the robustness of the results.

¹ The sample size varies across analyses depending on the availability of other variables used in the models.

Main findings and implications for practice

UK

We document a positive and significant association between the total disclosure quality of Strategic Reports and capital market benefits during the post-SR period, including higher liquidity, lower cost of capital, and more accurate and less dispersed analysts' forecasts. This supports our argument that information contained in a Strategic Report is incrementally useful to investors over and above the current reporting suite.

Further, when we decompose the total disclosure quality score into quality scores for specific components in order to identify those components of SR that are proving beneficial to the capital market, we observe that strategy and objectives (SO), environmental, employee, social, community and human rights information (EESCH), information linkage (LINK) and forward-looking orientation (FO) are the four components that consistently contribute significantly to all observed capital market benefits during the SR period. These components are among the key components aligning SR to the more holistic <IR> framework. This suggests that the provision of strategically important, socially relevant, well-connected and forward-looking information as part of this revised corporate reporting framework is valued and 'rewarded' by capital market participants.

We then extend the examination to include observations from the pre-SR period, and find that the effects of disclosure quality on liquidity and cost of capital are significantly more pronounced in the post-SR period. These findings provide evidence that SR is a more effective form of communication to the capital market than that achieved under the previous EBR regime, possibly because it better meets the information demands from financial report users with its broader scope and more connected style of presentation.

Australia

While we observe a negative sign on all the capital market outcomes, i.e. stock liquidity, cost of equity capital, and analyst forecast error and dispersion. Only the coefficient on analysts' forecast dispersion is statistically significant. This means we only find limited evidence that companies producing high quality OFR enjoy significant capital market benefits. This result is largely consistent with that in the UK during the pre-SR period, i.e. the EBR period.

In addition to examining the capital-market effects of the EER practice in Australia, this study takes a close look at the variation in the reporting practices between Australian and U.K. firms. According to the International <IR> Framework, report preparers should consider business model as a fundamental content element. In the U.K., it is a norm for listed companies to report on its business model, whereas, in Australia, only 27% of sample companies disclose its business model. Within firms making disclosures of business models, 78% (19%) of U.K. (Australian) sample companies make reference to its key stakeholders. Information linkage/connectivity is also a critical element under the International <IR> framework and in the Guidance on the Strategic Report. In particular, the linkage between a company's strategic objectives, KPIs and executive remuneration is under increasing scrutiny from investors and professional accounting bodies (PwC, 2014, 2017). In the U.K., 23% of FTSE 350 companies make an explicit link between strategic objectives, KPIs and executive remuneration, whereas, in Australia, only 4% of ASX 100 companies do.

Implications for practice

Collectively, the results suggest (i) Australian companies have considerable room for improvement towards reporting more in line with the principles of IR. (ii) there are significant economic benefits in moving towards a broader, more connected and more strategically oriented corporate reporting framework such as SR and IR.

These movements towards more extended forms of reporting are gaining traction in Australia, and they have recently been acknowledged in preparing the OFR in Australia (ASIC 2017). The policy makers in Australia could further consider incorporating IR principles into the regulatory guidance for OFR, a move that would be similar to the regulatory shift to SR in the UK.

Conclusions

This study performs a comparative analysis of the economic impact associated with EER in the UK and in Australia. In the UK, we study the economic consequences associated with the regulatory regime shift from the EBR (similar to the OFR in Australia) to SR (a broader form of corporate reporting highly aligned with IR). In Australia, we study the capital market outcomes associated with the quality of the OFR.

This study performs a comparative analysis of the economic impact associated with EER in the UK and in Australia. In the UK, we study the economic consequences associated with the regulatory regime shift from the EBR (similar to the OFR in Australia) to SR (a broader form of corporate reporting highly aligned with IR). In Australia, we study the capital market outcomes associated with the quality of the OFR.

We find that companies producing high quality strategic reports in the UK enjoy significant capital market benefits during the post SR period. These benefits are, however, not significant during the EBR period. Similarly, we find limited evidence of significant capital market benefits in Australia for those producing high quality OFRs. Collectively, these findings provide evidence that a broader, strategically oriented and more connected form of corporate reporting allows firms to communicate to capital markets more effectively.

This study presents one of the first pieces of evidence expanding prior research on IR (as a broader form of corporate reporting) to settings outside South Africa in a well-established, large capital market. The comparison of the effects between SR and EBR regimes offers direct evidence and timely policy implications to regulators and standard setters around the world as to the merit of broader corporate reporting. The results indicate that there is indeed economic benefit to expanding corporate disclosure to include more detail about a firm's long-term strategic plans and its impact on the social and natural environment. The higher the quality of SR, the larger is this benefit.

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