

# Integrated Reporting, Quality of Management, and Financial Performance

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**T**he concept of “integrated reporting” has been gaining prominence during the last few years. In its simplest form, integrated reporting can be understood as the convergence of the sustainability report and the financial report into a single “narrative”—a communication intended mainly for investors in which top management provides its views on how sustainability issues and initiatives are expected to contribute to the long-term growth strategy of the business.

While this is the most common understanding of “integrated reporting,” the International Integrated Reporting Council (IIRC) does not use the word “sustainability” in its definition of the concept. According to “The International <IR> Framework,” which is an articulation of the IIRC’s principles and methods, “an integrated report is a concise communication about how an organization’s strategy, governance, performance and prospects, in the context of its external environment, lead to the creation of value over the short, medium and long term.”<sup>1</sup> That said, the <IR> Framework recognizes the importance of looking at financial and sustainability performance in an integrated way—one that emphasizes the relationships between what it identifies as the “six capitals”—financial, manufactured, natural, human, intellectual, and social and relationship—and corporate performance over the three different time horizons (short, medium, and long term). The fundamental assumption of the Framework is that each of these types of capital—whether internal or external to the business, tangible or intangible—represents a potential source of value that must be managed for the long run in order to deliver sustainable value creation.

The reporting function is important because *all* stakeholders (not just investors) need to gain a deeper understanding of the interconnectedness between business results and the changing dynamics that characterize today’s business environment. Since management teams are dealing with these factors on a daily basis, they are generally in the best position to explain the links and dependencies between new sources of risks and opportunities and to outline the measures they are taking to address them and sustain value creation. Because most investors tend to focus on short-term financial results

and other stakeholders often care only about a single issue and are thus largely unaware of or uninterested in the tradeoff decisions facing the company, it is the role of management to explain to shareholders and stakeholders alike how and why these issues are interconnected. Integrated reporting provides an effective vehicle to do just that.

But integrated reporting is only the tip of the iceberg. It is the visible part of what is happening below the surface—namely “integrated thinking” and “integrated decision-making.” The <IR> Framework also emphasizes the importance of integrated thinking and its relationship to integrated reporting: “Integrated thinking is the active consideration by an organization of the relationships between its various operating and functional units and the capitals that the organization uses or affects.”<sup>2</sup> Companies that are able to articulate the relevance of sustainability issues to their long-term business success are likely to be those that are best equipped to address these issues internally.

We therefore consider integrated reporting to be a useful proxy for the overall quality of management, which increasingly involves managing intangible assets while also taking account of any negative effects (or “externalities”) on the environment and society. Doing so includes recognizing social trends that are likely to affect business developments, engaging with relevant stakeholders, understanding the impacts and dependencies of business activities on all types of capital, defining value creation from a broad societal perspective, providing appropriate internal incentives that encourage a long term-view, and having the right structures and systems in place to practice “integrated thinking” in all aspects of decision-making.

“Integrated thinking” also implies an ability to find an optimal balance between managing short-term business imperatives and ongoing value creation. Sustainable value creation depends on a company’s ability to remain competitive in a fast-changing business environment, which in turns depends on its ability to manage new types of risks and opportunities associated with environmental, social, and governance (ESG) issues. Effective management of ESG issues is therefore linked to continuous investment in a company’s long-term sources of competitiveness, including innovation management capabili-

1. “The International <IR> Framework,” by the International Integrated Reporting Council, December 2013, p. 7.

2. *Ibid.*, p. 2.

ties and talent management, as well as operational excellence. Companies that are able to manage these issues more effectively are more likely to remain competitive and to continue to create value over the long term. Superior quality of management should result in above-average returns over the business cycle.

The rest of this article is organized into five sections. The first describes our database and methodology. The second section examines changes in the degree of integrated reporting over a recent two-year period (2011 and 2012) and the major differences by industry. Section three discusses the relationship between integrated reporting and the quality of management. Section four does the same for the relationship between integrated reporting and financial performance. In the last section, we summarize our main results and their implications for practitioners, and close with suggestions for future research.

## Methodology

Every year RobecoSAM, an asset manager that offers clients a comprehensive range of differentiated and complementary Sustainability Investing solutions,<sup>3</sup> conducts a Corporate Sustainability Assessment (CSA) that analyzes how large public companies manage environmental, social, governance, and economic issues to stay competitive and continue to create value over the long term.<sup>4</sup> RobecoSAM invites the world's largest 2,500 publicly traded companies to participate in its annual CSA. As part of these annual assessments, RobecoSAM has been looking for evidence of integrated reporting since 2009.

Integrated reporting is a relatively new approach to reporting that has been adopted by a fairly small number of companies. In the absence of established and recognized frameworks for integrated reporting and measurement, and lacking reporting standards for ESG information that are clearly relevant to investors, companies have experimented with different approaches.<sup>5</sup> As their integrated reporting practices have evolved and become more sophisticated, so has RobecoSAM's methodology.<sup>6</sup>

During the past two years, RobecoSAM has conducted a systematic search for a number of specific indicators of integrated reporting in the 2011 and 2012 Annual Reports of some 2000 companies from all parts of the world.<sup>7</sup> Because the database is so rich, a substantial amount of additional analysis could be done. The purpose of this paper is to present some early preliminary results from this undertaking that could be useful to companies and investors.

First of all, RobecoSAM looked for examples of environmental or social initiatives that led to either cost savings or new revenue streams. Because "integrated reporting" is an emerging approach to reporting that is still difficult to assess due to the absence of a standardized reporting framework, RobecoSAM's assessment uses the following proxy for integrated reporting: management decisions to include, *in the main section of the Annual Report*, specific examples of sustainability initiatives and how they impact financial performance.

When reviewing these examples, the analysts distinguished between *strategic* sustainability initiatives (typically group-wide company initiatives related to the company's core business or main products) and sustainability *programs* (initiatives focused on non-core business activities or activities in a single location). Furthermore, we differentiated between companies that articulated the links between sustainability initiatives and business results in a *qualitative* way from those that were able to *quantify* the impact of their sustainability initiative on the business performance in financial terms. Such examples illustrate the IIRC's Guiding Principle of "connectivity of information," which is defined as "a holistic picture of the combination, interrelatedness and dependencies between the factors that affect the organization's ability to create value over time."

Second, RobecoSAM's assessment was strictly confined to the main section of the Annual Report (or equivalent financial report, such as Form 10-K), in most cases the Management Discussion section. Even though companies increasingly

3. RobecoSAM is an investment specialist focused exclusively on Sustainability Investing. Its offerings comprise asset management, indices, private equity, engagement, voting, impact analysis, and sustainability assessments, as well as benchmarking services. Asset management capabilities include a range of ESG-integrated investment and theme strategies (in listed and private equity) catering to institutional asset owners and financial intermediaries across the globe. Together with S&P Dow Jones Indices, RobecoSAM publishes the globally recognized Dow Jones Sustainability Indices (DJSI). In 1995, RobecoSAM was founded on the conviction that integrating ESG factors into traditional financial analysis leads to a better informed investment decision. RobecoSAM is a member of the global pure-play asset manager Robeco, which was established in 1929 and was acquired by ORIX Corporation in 2013. As of June 30, 2013, RobecoSAM listed and private equity\* had assets under management, advice and/or license of approximately USD 11.8 billion. Additionally, RobecoSAM's Governance & Active Ownership\*\* team had EUR 53 billion of assets under engagement and EUR 35 billion of assets under voting. \*RobecoSAM Private Equity is the marketing name of the combined private equity divisions of Robeco Institutional Asset Management B.V. ('Robeco') and its fully owned subsidiary, RobecoSAM AG ('RobecoSAM'). Any funds or services offered by RobecoSAM Private Equity are managed and offered by Robeco, who may have delegated certain investment advisory functions to RobecoSAM. \*\* RobecoSAM's Governance & Active Ownership team is a brand name of Robeco. Copyright © 2014 RobecoSAM – all rights reserved.

4. This industry-specific questionnaire features approximately 80 – 120 questions on financially relevant economic, environmental, and social factors and is the starting point

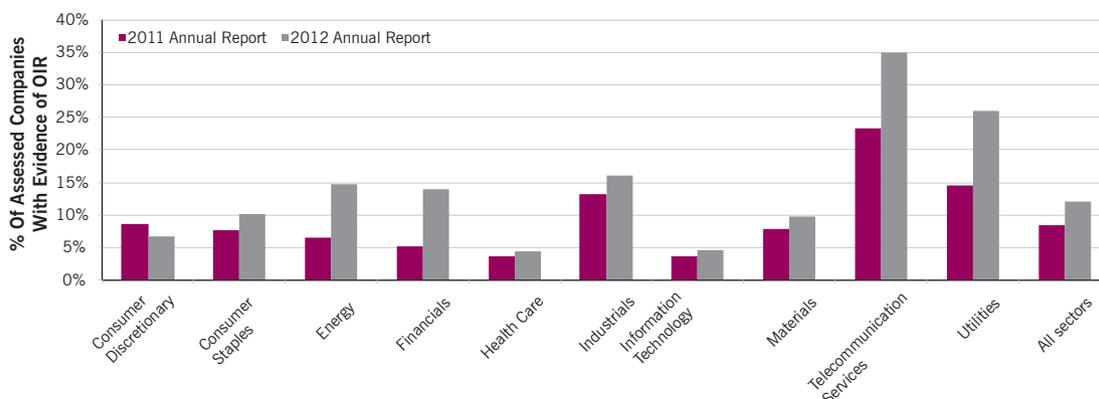
for RobecoSAM's annual assessment. The CSA is designed to capture both general and industry-specific criteria covering the economic, environmental, and social dimensions of performance. Each of the three dimensions is assessed through 6 – 10 criteria, and each criterion can contain between 2 – 10 questions, resulting in a total of 80 – 120 questions, depending on the industry. Each criterion is worth up to 100 points and is assigned a weight (percentage) of the total questionnaire. The criteria within each dimension roll up to the dimension weight. For each company, a Total Sustainability Score of up to 100 points is calculated based on the pre-defined weights established for each question and criterion. More information on RobecoSAM's methodology is available in "Measuring Intangibles" [http://www.robecosam.com/images/CSA\\_methodology\\_Brochure.pdf](http://www.robecosam.com/images/CSA_methodology_Brochure.pdf).

5. The first proposed global framework for integrated reporting was published in December 2013. Other relevant organizations are the Global Reporting Initiative, which has a multi-stakeholder focus, and the Sustainability Accounting Standards Board, which has an investor focus. "The International <IR> Framework".

6. In previous years, the assessment focused on whether the Annual Report included a discussion of material issues and related KPIs and did not ask companies to highlight examples of revenue generation or cost saving included in their Annual Reports.

7. The 2000 firms assessed are a representative sample of the S&P Global Broad Market Index since the sample is based on a geographical and sector mix that closely mirrors the S&P broader universe of approximately 10,000 companies. Analyzing the reports took approximately 2,000 man hours, a task that was completed in July of 2013.

Figure 1 Integrated Reporting by Sector 2011 and 2012



include a separate chapter on sustainability in their Annual Report, the analysts purposely did not include such chapters in their review, since this would be equivalent to producing a “combined report” rather than an “integrated report.” By focusing on the main section of the Annual Report, and not a separate section on sustainability or a separate sustainability report, we feel that we had a better chance of identifying information the company believes will be important to investors, which are the main target audience of the <IR> Framework. For “the primary purpose of an integrated report,” as noted in the Framework’s mission statement “is to explain to providers of financial capital how an organization creates value over time.”<sup>8</sup>

Since analysts and investors are unlikely to read information contained in a separate section or report, our feeling is that the whole exercise of sustainability reporting could prove to be self-defeating if this discussion does not become an integral part of the management review of business operations. Moreover, embedding discussions of and information about sustainability in the main section of the report sends a strong signal to investors that top management is involved in managing these issues and can clearly articulate how they contribute to the corporate strategy and value creation.

Finally, for the purposes of RobecoSAM’s assessment, we were not specific in prescribing the types of environmental or social examples we expected to find in the report (examples of energy efficiency or biodiversity preservation efforts were accepted as environmental examples, in the same way as health and safety measures or ongoing training for employees were accepted as social examples), preferring to allow companies to report on what they consider most relevant to them in terms of the examples they used.

### Overview of Integrated Reporting Practices

We now provide an overview of the integrated reporting practices of the companies in our sample that is based on a comparison of their most recent two annual reports, those for 2011 and 2012. In doing so, we report on the distribution of practices by both the type of disclosure (environmental vs. social and cost savings vs. revenue generation) and the degree of sophistication we think it shows.

As clear evidence that integrated reporting is still in its early stage of development, only 12% of the companies in our 2012 sample provided at least one example of how a social or environmental initiative contributed to costs savings or revenue generation. Nevertheless, this represents a 50% increase in the percentage of companies that did so in 2011 (8%). And, as can be seen in Figure 1, there was substantial variation across sectors, both in terms of the percentage of companies practicing some degree of integrated reporting and in the growth between 2011 and 2012. The sectors with the highest percentages of companies providing examples in 2012 were Telecommunications (35%), Utilities (26%), Industrials (16%), Energy (15%), and Financials (14%). And the highest growth rates were in Telecommunications (50%), Utilities (79%), Financials (172%), and Energy (125%).

Environmental issues are extremely important, of course, in the Utilities, Industrials, and Energy sectors—and the same is true of social issues in Telecommunications and Financials. The two sectors with the lowest degrees of integrated reporting were Information Technology (5%) and Healthcare (5%). Although a few specific industries within these sectors are highly affected by environmental and social issues (notably, semiconductors & semiconductor equipment in the Information Technology sector and pharmaceuticals in Healthcare sector), the other industries classified in these

8. “But, as the statement goes on to say, ‘An integrated report benefits all stakeholders interested in an organization’s ability to create value over time, including employees,

customers, suppliers, business partners, local communities, legislators, regulators and policy-makers.” “The International <IR> Framework,” p. 4.

Figure 2 **Integrated Reporting Practices by Type 2012**

	Cost savings	Revenue generation
Environmental	37%	37%
Social	9%	17%

sectors do not have pressing environmental or social issues (think for example, of the software industry in Information Technology, or life sciences tools & services in Healthcare). But because the Information Technology sector comprises six industries and the Healthcare sector has five, the importance of environmental and social issues for specific industries may well be diluted in these aggregated results.

We also found considerable variation in the type of integrated reporting. In both the 2011 and the 2012 Annual Reports, the most commonly reported examples of integrated reporting were descriptions of environmental initiatives that either led to cost savings or contributed to additional revenue. Figure 2 shows the percentage for each four types of the 359 examples of integrated reporting in 2012.

The much larger number of environmental examples can be partly explained by the fact that environmental issues are more tangible and readily quantifiable than social issues. The impact of energy-efficiency initiatives, for instance, can be measured in terms of changes in energy consumption and easily translated into changes in energy-related costs. This applies to a company's customers' operations as well as its own. Selling more energy-efficient products (whether it relates to industrial machinery or home appliances) that reduce the total cost of ownership over the lifespan of the product makes the company's value proposition more attractive and can therefore contribute to revenue growth. In fact, the vast majority of the environmental examples we found were related to energy consumption, suggesting that companies are finding it much harder to provide cases related to other environmental resources, such as water or eco-system services. This is likely attributable to the absence of pricing mechanisms for these other kinds of natural resources or capital.

This challenge is even more formidable when it comes to assessing the value of corporate investments in various types of social capital, such as employee motivation and support from local communities and regulators. In such cases, the value created by corporate investments is not easy to measure. And this, of course, makes it more difficult for companies to make a compelling business case for how the management of these intangible assets contributes to financial performance and long-term value creation. Given these different degrees of

Figure 3 **Integrated Reporting Practices by Sophistication 2012**

	Program	Strategic
Qualitative	19% (mid, 50 points)	41% (mid, 75 points)
Quantitative	9% (low, 25 points)	31% (high, 100 points)

measurability, it is not surprising that companies were twice as likely to associate revenue generation and cost savings with environmental initiatives as with social initiatives.

As also reported in Figure 2, of the companies in our sample that provided examples of social initiatives, twice as many cited revenue generation rather than cost savings as the primary financial benefit. This likely reflects the large representation in our sample of Financial and Telecommunication companies, which are increasingly finding ways to create revenue growth out of socially-oriented business initiatives (e.g., affordable banking services and mobile-enabled services).

Finally, as can be seen in Figure 3, we also found considerable variation in the degree of sophistication of integrated reporting by companies that have chosen to do it. Our evaluation was based upon two main criteria—whether the examples were strategic initiatives or non-core programs, and whether or not management assigned a monetary value to the initiative. Depending on the combination of these two criteria, we assigned companies sophistication scores of 25, 50, 75, or 100. We used these scores to classify all the integrated reporting examples in our sample as having degrees of sophistication that ranged from low (25) to medium (50 and 75) to high (100).<sup>9</sup>

While only a small percentage of companies are practicing integrated reporting, those that are doing so are focused more on strategically important issues (over 70% of the examples) than more ancillary programs. The fact that integrated reporting practices tend to focus more on describing strategic (as opposed to non-core “program”) initiatives indicates that social or environmental initiatives are more likely to be associated with the notion of “materiality” and to have a material impact on corporate financial performance if they are implemented on a large scale. This seems self-explanatory since small ad hoc initiatives in small business divisions are unlikely to “move the needle” for group-wide results. Analysts are keenly aware of this, and will likely disregard small scale initiatives as a sign of “greenwashing,” as opposed to a potentially significant future growth driver. And for managements sensitive to the risk of their companies being perceived as greenwashing, such sensitivity may well be

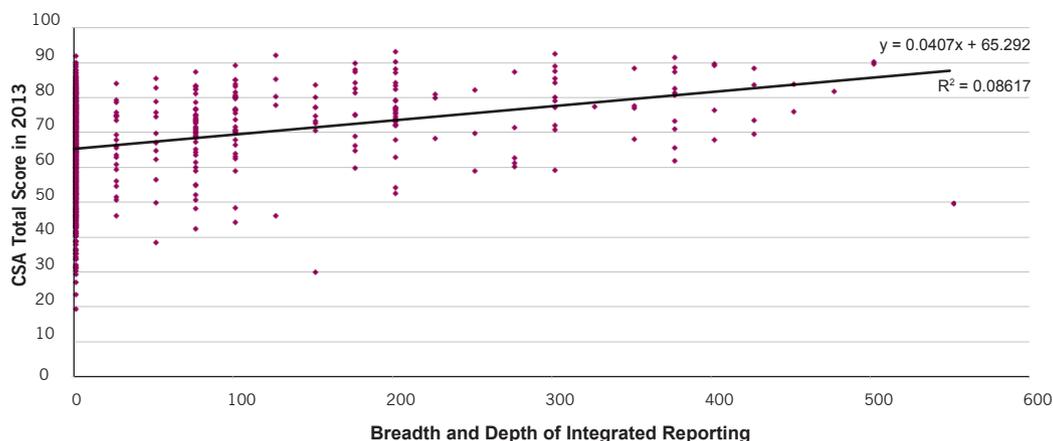
9. Below are the possible “examples” scores:

- 25 points: only have a qualitative example
- 50 points: program example + quantified (link to monetized impact)

- 75 points: qualitative strategic example but not quantified (no link to monetized impact)

- 100 points: strategic example + quantified (link to monetized impact)

Figure 4 Evidence of Integrated Reporting and Quality of Management



leading them to avoid such examples in their annual reports until their initiatives reach sufficient scale to affect the core business.

What investors care about are strategic issues that will have a material impact on a company's financial performance. However, as is clear from Figure 3, in both cases most of these examples were qualitative (60%) as opposed to quantitative (40%). While this is understandable for the reasons described above, it also implies that more effort is required on the part of investors to estimate the magnitude of the financial impact of even strategic issues.

### Quality of Management

In the next part of our study, we tested the relationship between a company's integrated reporting and our assessment of its overall management of ESG issues. We consider ESG management to be a proxy for overall quality of management when viewed in terms of what is required to create value over the long term. While our data are admittedly limited to a two-year time frame, they do enable us to address a topic that is frequently being raised but has received virtually no empirical analysis to date: the relationship between integrated reporting and integrated thinking. In other words, what evidence do we have that companies that have embraced integrated reporting are more likely than others to manage sustainability issues on a strategic level and in their daily operations?

To try to answer this question, we looked at how companies with evidence of integrated reporting performed in RobecoSAM's overall annual Corporate Sustainability Assessment (CSA).<sup>10</sup> The CSA includes approximately 20 industry-relevant issues and consists of approximately 100 questions that seek to determine how companies manage environmental, social, governance, and long-term economic issues.<sup>11</sup> Based on the results of the assessment, the companies receive a total score ranging from 0 to 100 points.

Our analysis provides suggestive evidence of a positive relationship between effective management of ESG issues and integrated reporting. As reported in Figure 4, companies with higher levels of integrated reporting (as measured by their total score on all four examples of integrated reporting)<sup>12</sup> tend to score higher on the CSA. Our regression analysis confirms that there is a positive relationship between management of ESG issues and integrated reporting but this relationship is relatively weak ( $R^2 = 0.08$ ).

These results hold for each of the 10 sectors, although the differences were greater in some sectors (such as Healthcare, Consumer Discretionary, and Telecommunications) than others (Consumer Staples and Energy). The positive relationship was statistically significant for 6 out of 10 sectors<sup>13</sup>, with a confidence level above 95% in most cases. In Consumer Discretionary, Financials, and Industrials, the confidence level was 99.9%.

These data suggest that companies that proactively manage the risks and opportunities arising from social and

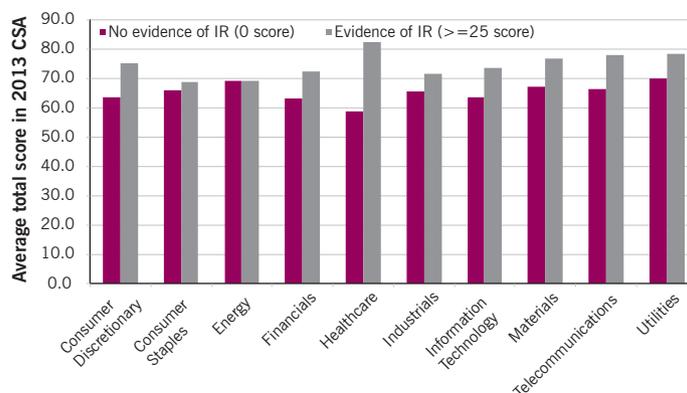
10. This analysis was conducted on a subset of companies that participated directly in the Corporate Sustainability Assessment (approximately 800 companies) and leaves out the other 1200 companies that were assessed solely based on publicly available information, since their total scores are not comparable.

11. Integrated Reporting is one of the questions included in the CSA but its weight is very low (less than 2% of the total CSA score) so its impact on the total score is negligible.

12. The four examples of integrated reporting are: (1) environmental example of cost savings, (2) environmental example of revenue generation, (3) social example of cost savings, and (4) social example of revenue generation. The maximum score for each example is 100 points, hence the maximum score for all four examples is 400 points. We also look at evidence of a process to identify material issues (200 points), so the maximum score all together is 600 points.

13. It was not statistically significant for Consumer Staples, Energy, Telecommunications, and Utilities.

Figure 5 Differences in Quality of Management by Integrated Reporting Score



environmental issues are also more likely to communicate on sustainability issues in an integrated way. This confirms our view that integrated reporting reflects integrated thinking and an integrated approach to the management of sustainability issues.

But even if the relationship is a fairly strong one, we are not able to untangle the cause and effect relationship. Does integrated reporting foster integrated thinking, or is integrated reporting a natural consequence of integrated thinking? Our view is that these are related to each other in a mutually reinforcing cycle.

Focusing only on the use of environmental and social examples, we find that, across all sectors, companies with evidence of integrated reporting (that is, at least one example and a score above 0) scored on average almost 15% higher on their overall sustainability performance than companies with no evidence of integrated reporting (those with a score of 0 on all four examples of integrated reporting). Those with some degree of integrated reporting had an average total score of 74, as compared to an average total score of 65 for companies without. This positive relationship was observed in all sectors. In most sectors, companies with evidence of integrated reporting scored between 10% and 20% higher on ESG quality of management than those without.

We also divided the sample into three groups: those companies with no evidence of integrated reporting (score of 0) scored 65 on average on their overall sustainability performance; those with low to medium evidence of integrated reporting (score of 25-75) scored 71 on average on their overall sustainability performance; and those with a high degree of integrated reporting (score of 100) scored 79 on average on their overall sustainability performance.

Although these differences in the quality of ESG manage-

ment scores were statistically significant for the entire sample of companies, such differences were particularly striking in the Healthcare sector. A total of 39 Healthcare<sup>14</sup> companies participated in the assessment. Of those, the five companies (13%) that had an integrated reporting score of 25 or higher had an average CSA score of 82, which was 40% higher than companies with no evidence of integrated reporting (which had an average score of 59). Moreover, this superior performance seemed to be concentrated in one industry (pharmaceuticals), as four out of five were pharmaceutical companies (the other one was a biotechnology company).

One explanation for this finding is the intense scrutiny of the pharmaceutical industry, which is subjected to tremendous pressure from stakeholders (civil society and governments alike) to demonstrate the social value of the drugs it develops, manufactures, and sells. For instance, pharmaceutical companies need to show how their treatments are helping to reduce the overall costs of healthcare through increased efficacy and better health outcomes. They also need to show how they are making their products affordable to lower-income countries and positioning themselves in tomorrow's most populous and fast-growing regions of the world. Finally, they have to reassure all stakeholders that clinical trials and marketing efforts are conducted in an ethical way.

Another factor that could be driving the particularly strong result for this small sample of pharmaceutical companies is that two of them were the first two companies on record to formally issue an integrated report some 10 years ago. Since that time, a third one has also been a pioneering practitioner of sustainability. Thus, these three companies have extensive experience in practicing integrated reporting and integrated thinking, as reflected in their high scores on both our integrated reporting and ESG quality of management scores.

14. The Healthcare sector consists of five industries with the following numbers of companies participating directly in the assessment: four companies in biotechnology, two companies in life sciences tools & services, 12 companies in healthcare equipment and

suppliers, six companies in healthcare providers and services, and 15 companies in pharmaceutical.

Figure 6 Ten Year ROIC Average by Sector (in %)

Sectors	With Evidence of Integrated Reporting	Without Evidence of Integrated Reporting	Difference
Consumer Discretionary *	9.5	13.9	-4.5
Consumer Staples	12.3	14.6	-2.3
Energy	10.3	11.6	-1.4
Financials	4.9	7.0	-2.1
Healthcare *	15.8	14.0	1.9
Industrials	13.3	13.2	0.1
Information Technology	15.8	14.7	1.1
Materials	7.8	11.4	-3.6
Telecommunication	10.7	11.2	-0.5
Services			
Utilities	6.9	6.8	0.1

\* The negative relationship for Consumer Discretionary was statistically significant with 90% confidence level.

\* The positive relationship for Healthcare was statistically significant with 90% confidence level.

But, as can be seen in Figure 5, the data from virtually all sectors support our view that companies that are committed to integrated reporting also tend to be more effective managers of ESG issues.

### Financial Performance

Although the relationship between integrated reporting and integrated thinking is an important one, for investors the ultimate test is the implication for financial performance. This is another important question that has been largely unaddressed because of data limitations.<sup>15</sup> In the third and final part of our study, we explored the relationship between integrated reporting and financial performance in a very preliminary way, acknowledging that this warrants further analysis in the future. Again, we cannot specify the cause and effect relationships. Does integrated reporting lead to better financial performance, partly through better ESG management, or vice versa? In a study published in 2011, Ioannou, Serafeim, and one of the present writers (Eccles) provided strong evidence that superior ESG management does indeed contribute to superior financial performance over the long term.<sup>16</sup> Using RobecoSAM's data and other data sets, they also found that companies with superior ESG management were more trans-

15. A few exceptions are RobecoSAM's "Alpha from Sustainability" study (2011) which showed a positive relationship between sustainability and financial performance, suggesting that superior returns can be generated by selecting sustainability leaders and avoiding sustainability laggards (see [http://www.robecosam.com/images/Alpha\\_from\\_Sustainability\\_e.pdf](http://www.robecosam.com/images/Alpha_from_Sustainability_e.pdf)) and Eccles and Serafeim (2013) who found that firms with better financial performance are more likely to issue an integrated report. "Teaching Note: Natura Cosméticos, S.A.," by Robert G. Eccles and George Serafeim, Harvard Business School Publishing, c. The President and Fellows of Harvard College, 2013. This was not the case for firms with poor financial performance, suggesting that integrated reporting

Figure 7 Two Year ROIC Average by Sector (in %)

Sectors	With Evidence of Integrated Reporting	Without Evidence of Integrated Reporting	Difference
Consumer Discretionary *	10.0	14.8	-4.7
Consumer Staples	11.7	14.8	-3.0
Energy	7.3	9.9	-2.6
Financials	5.1	6.3	-1.2
Healthcare *	18.4	13.4	5.0
Industrials	13.1	15.3	-2.2
Information Technology	15.2	13.3	1.9
Materials	8.6	10.5	-1.9
Telecommunication	9.8	9.9	-0.1
Services			
Utilities	6.2	6.4	-0.2

\* The negative relationship for Consumer Discretionary was statistically significant with 90% confidence level.

\* The positive relationship for Healthcare was statistically significant with 90% confidence level.

parent in their external reporting on ESG issues which, as noted, is a proxy for integrated reporting.

In our study, we used return on invested capital (ROIC) as the measure of financial performance. Return on invested capital is a good indicator of financial performance since it captures both profitability and capital efficiency. Companies that earn a return on capital above their cost of capital create value, and typically generate superior investment returns to equity holders over time as a result of higher reinvestment rates and/or higher dividends and share buybacks.<sup>17</sup> The greater the spread between the return on capital and the cost of capital, the higher the expected return for investors. No ratio is perfect, but ROIC provides a useful indicator since it also accounts for the amount of financial leverage a company employs, enabling better comparison across industries and companies. What's more, we used a 10-year ROIC average since that provides a better indication of returns over an entire business cycle.

Our results did not support our hypothesis. We found no conclusive evidence that integrated reporting practices are correlated with companies achieving a higher ROIC over the last decade. But nor did companies appear to be penalized for their investments in and professed commitments to sustain-

is not a "smoke screen" for distracting the market from poor financial performance. However, they did not find the firms with better ESG performance were more likely to issue an integrated report. Our results above suggest that such a relationship exists.

16. "The Impact of Corporate Sustainability on Organizational Processes and Performance," by Robert G. Eccles, Ioannis Ioannou, and George Serafeim, Harvard Business School Working Paper Series 12-035.

17. Of course, this does not happen if, among other things, the company does not reinvest retained earnings intelligently, overpays for acquisitions and fails to find the anticipated synergies, or pays excessive compensation to the top executives.

Figure 8 Ten Year ROIC Average by Industry (in %)

Sector	Industry	With Evidence of IR	Without Evidence of IR	Difference
Consumer Discretionary	Household Durables	10	6.7	3.3
Consumer Discretionary	Media	12.5	9.6	2.9
Consumer Staples	Beverages	12.7	11.2	1.5
Health Care	Pharmaceuticals *	17.1	14.4	2.7
Industrials	Building Products	11.7	6.0	5.7
Industrials	Construction & Engineering	13.4	10.6	2.8
Industrials	Machinery and Electrical Equipment	15.8	13.1	2.7
Industrials	Transportation and Transportation Infrastructure	12.2	7.6	4.6
Information Technology	Software **	19.8	12.4	7.4
Information Technology	IT services & Internet Software and Services	26.5	22.5	4.0
Materials	Steel	15.6	10.7	4.9

\* The positive relationship for pharmaceuticals was statistically significant with 95% confidence level.

\*\* The positive relationship for software was statistically significant with 90% confidence level.

ability. In fact, the 10-year average ROICs of our sample of integrated reporting companies were statistically indistinguishable from the broad sample. Since integrated reporting is a relatively new phenomenon, we repeated the analysis using five-year ROIC and two-year ROIC averages. Again, we found no evidence of a correlation between integrated reporting and these shorter-term measures of financial performance.

When we then analyzed the results by sector, we found positive relationships between integrated reporting and financial performance in two sectors: Healthcare and Information Technology. These positive relationships (though statistically significant only in the case of Healthcare) were apparent when we looked at 10-year ROIC averages or two-year ROIC averages (as reported in Figures 6 and 7, respectively) suggesting that this relationship applied for these industries regardless of the time frame used in the analysis.

Perhaps more telling, the gap in terms of financial performance appears to have increased between companies with evidence of integrated reporting and those without over the last two years. In the Healthcare sector, companies with evidence of integrated reporting had a two-year ROIC average of 18.4%, as compared to 13.4% on average for those without evidence of integrated reporting. In the Information Technology sector, companies with evidence of integrated reporting had a two-year ROIC average of 15.2%, as compared to 13.3% on average for those without evidence of integrated reporting.

We then analyzed the results by industry and found that 11 out of 59 industries had positive relationships (Figure 8), although only two were statistically significant.

In the Healthcare sector, where we assessed 111 compa-

nies, our results were strongly driven by the pharmaceutical industry, one of five industries in this sector.<sup>18</sup> Pharmaceutical companies with evidence of integrated reporting had a 10-year ROIC average of 17.1%, as compared to 14.4% for pharmaceutical companies with no evidence of integrated reporting.

It is interesting to note that four of the five companies we identified in the previous section as companies with better quality of management also had a higher ROIC average over the last 10 years than the rest of the Healthcare sector. When looking at the last two years, this difference was even more pronounced. The four pharmaceutical companies had a ROIC average of 21.7%, as compared to 14% for the rest of the pharmaceutical industry. This suggests opportunities for further analysis regarding the relationship between quality of management—in our case, quality of ESG management—and financial performance.

One possible explanation for the weak results on the relationship between integrated reporting and financial performance is time lags. As Eccles et al. (2011) suggested, there is a significant time lag before better ESG performance results in superior financial performance since the benefits from superior ESG performance are not immediate. There is also a time lag between implementing integrated reporting and getting the benefits from it of superior ESG performance. Integrated reporting is a relatively new management practice and most companies that do so have only been practicing it for a few years. We should also note that we used proxies for integrated reporting and it is likely that our methodology focused on reporting examples does not fully capture the benefits of companies practicing integrated

18. The Healthcare sector consists of five industries with the following numbers of companies assessed: 10 companies in biotechnology, seven companies in life sciences

tools & services, 29 companies in healthcare equipment and suppliers, 26 companies in healthcare providers and services, and 39 companies in pharmaceutical.

reporting in the more holistic way described by the IIRC. Here too there are opportunities for future research.

## Conclusion

Our starting hypothesis was that the variables examined in this article are deeply connected and mutually supportive. Integrated reporting is linked to integrated thinking which results in managing the business in a way to meet near-term priorities while also achieving the company's long-term vision and goals. Such integrated thinking and management are critical to maintaining long-term competitiveness and business resilience in a changing environment which, in turn, are the keys to superior long-term financial performance and returns to investors.

Using the RobecoSAM proprietary database, we examined trends in integrated reporting during the past two years while looking for evidence of a relationship between integrated reporting and both quality of management and financial performance. Although the percentage of companies practicing integrated reporting is small, the number is growing. We also found a statistically significant relationship between the practice of integrated reporting and quality of ESG management, which we argued is indicative of the overall quality of management over the long term. Finally, we found no statistically significant relationship between integrated reporting and financial performance and discussed the possible reasons for this.

Because of difficulties in defining (much less measuring) corporate attributes like quality of management and long-term competitiveness, analytical work like ours is forced to rely on proxies that have inherent limitations. And although we have good reason to believe that such attributes are mutually reinforcing (if not completely interdependent), we also understand that causal relationships are hard to prove. Integrated reporting, for instance, may well be the result of integrated thinking in some companies. But in other cases, the adoption of integrated reporting practices could end up providing the catalyst for more integrated thinking, thereby giving rise to a virtuous cycle of corporate reporting and decision-making.

Indeed, as we suggested at the outset of this article, there might be an element of self-fulfilling prophecy between management's belief in the importance of a specific environmental or social issue, its decision to tackle it on a strategic level and then communicate its efforts (and their effectiveness) to investors through integrated reports, and the importance that investors end up attaching to it. The possibility of this response by companies and their investors suggests the value of more analysis of data about the "materiality" of different environmental and social issues—in particular, on the expected effects on profitability and long-term value creation

of corporate efforts to address such issues—and on how such efforts are likely to be viewed by investors and other important stakeholders.

And, as the last statement suggests, investors also stand to gain from enlarging their analysis beyond financial results and using integrated reporting and other environmental and social data points to develop a more informed picture of a company's management approach and business processes. Viewed in this light, integrated reporting could turn out to provide a reliable way to identify high-quality businesses. At the very least, our findings point to clear opportunities for more detailed analysis based on the RobecoSAM database combined with other metrics, such as accounting and stock price performance. One goal of such analysis would be to investigate the possibility that the practice of integrated reporting—along with superior (or improvements) in ESG performance—could come to be viewed by investors as predictors of superior future financial performance.

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