THEORETICAL INSIGHTS ON INTEGRATED REPORTING AND EXTERNALITIES*

Assoc. Prof. Dr. Seçil SİGALI**

Prof. Dr. Çağnur KAYTMAZ BALSARI***

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ABSTRACT

Externalities are the main source of most of the conflicts between businesses and public. There are several ways to address the externalities problems in economic literature such as; property rights, contractual arrangements and government regulation. Integrated reporting could improve the proposed solutions to externalities in economic literature by providing case specific information and consistent metrics for measurement. This paper views integrated reporting as a tool to overcome the externalities problems by reviewing theoretical background, pointing out issues regarding integrated reporting and providing directions for future research.

Keywords: Integrated Reporting, Externalities, Disclosure

JEL Classification: M40, M41, M48

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** Dokuz Eylül University, Maritime Faculty, secil.varan@deu.edu.tr, orcid.org/0000-0002-8037-6619
*** Dokuz Eylül University, Faculty of Business, cagnur.kaytmaz@deu.edu.tr, orcid.org/0000-0002-6320-0080
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ENTEGRE RAPORLAMA VE DIŞSALLIKLAR SORUNU İLE İLGİLİ TEORİK YAKLAŞIMLAR

ÖZ

Dışsallıklar sorunu, işletmeler ve kamu arasındaki çoğu ihtilafın en önemli nedenidir. Ekonomi literatüründe dışsallıklar sorunlarının çözülmesi ile ilgili olarak tartışılan başlıca çözüm yolları; mülkiyet hakları, sözleşmelere dayalı anlaşmalar ve resmi düzenlemeler olarak sıralanabilir. Söz konusu çözümler, entegre raporlamada dışsallıklar sorunları ile ilgili farklı durumlara özgü bilgilerin açıklanması ve dışsallıkların ölçülmesinde uygun ölçütler kullanılması ile geliştirilebilir. Bu çalışma, entegre raporlamayı dışsallıklar sorunlarının çözümünde bir araç olarak değerlendirmekte ve konu ile ilgili teorik altyapı ışığında entegre raporlama ile ilgili sorunları ele alarak gelecek çalışmalar için öneriler sunmaktadır.

Anahtar Kelimeler: Entegre Raporlama, Dışsallıklar, Açıklamalar

JEL Sınıflandırması: M40, M41, M48

1. INTRODUCTION

"Externalities" can be defined as a loss or gain in the welfare of one party resulting from an activity of another party, without there being any compensation for the party that carries the lost. Solution for the externalities problems has long been a discussion in economics literature. Externalities have been viewed as a market failure and economics literature introduced government intervention as a tool to solve these problems. Public ownership of industries with positive externalities such as regarding negative externalities can be explained by market failure argument. However, Coase (1960) suggests that externalities issues can be solved by the market, without government intervention.

Today, corporations are one of the major parties that are causing or providing externalities in the world. However, the solutions provided for negative externalities by the economic theory such as property rights, contractual arrangements and government regulations are quite general and not case specific. Additionally; positive externalities are not encouraged.

Four factors make property rights and contractual arrangements less effective solutions; which are (i) scientific uncertainty regarding mitigation benefits and costs; (ii) varying preferences and perceptions across heterogeneous populations; (iii) asymmetric information; and (iv) the extent of compliance and new entry (Lidecap, 2014). Especially for environmental problems, rights are harder to be defined, and the measurement of the costs of these problems is problematic. Additionally, contractual arrangements may fail to solve the externalities problems since the costs of bargaining and striking an agreement may be very high: "… a factory might find it impossible to negotiate directly with each affected citizen to decrease pollution" (Cowen, 2007).

Governments impose taxation for some types of externalities as a regulatory solution to correct a market failure. However, taxation can only be imposed in a narrow set of externalities and too general to solve them case by case.

From the perspective of the agency theory, information asymmetry among the related parties makes it even more costly to achieve a solution through imposing property rights, contractual agreements and regulation. Disclosure of information on externalities by corporations in corporate social responsibility or integrated reports, essentially turns private information into public information and may therefore reduce information asymmetry (Hung et al., 2015). Additionally, disclosures as carbon emissions and energy consumption are providing information on the externalities caused/provided by a corporation and gives metrics to measure the impact of externalities to the corporation and to the other related parties. By these metrics, externalities might be measured by case to reach better solutions via property rights, contractual arrangements and/or government regulations. Hence integrated reports serve as a key to address externalities issues in economic theory by reducing information asymmetry. However, integrated reporting has its own limitations due to the measurement and assurance issues. The aim of this paper is to discuss the contribution of integrated reporting to the externalities issues in economic theory, and point out the measurement and assurance challenges regarding integrated reporting.

Although the shareholder theory that focuses on "maximizing shareholder wealth within legal constraints and basic social norms" has been a dominant assumption throughout research in economics, finance, and accounting; corporate social responsibility (CSR) reporting suggests that firms are motivated to make decisions that are not always shareholder-wealth-maximizing, as suggested by the stakeholder theory (Friedman, 1970), and accordingly, firms strike a balance between shareholder interests and the interests of other stakeholders (Carroll, 1991, Huang and Watson, 2015).

Proponents of political cost theory on the other hand, argue that managers disclose CSR activities in order to avoid more rigorous mandated disclosures, regulation, or litigation. A corporation, anticipating demands and constraints imposed by external factors (legislatures, regulatory agencies, public interest groups, or the media) attempts to ease those pressures by strengthening the voluntary side of corporate activities through CSR disclosures. Accordingly, legitimacy theory as Suchman (1995) defines as "a generalized perception or assumption that the actions of an entity are desirable, proper, or appropriate within some socially constructed system of norms, values, beliefs, and definitions." focuses on the public pressure on the companies regarding the externalities issues.

The CSR reporting differs from the traditional reporting frameworks as it includes ecological or environmental and social measures that can be difficult to assign appropriate means of measurement (Hostut and Van Het Haf, 2013). Developments in CSR reporting eventually led to the Integrated reporting (IR) practices that 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" (IIRC, 2013).

Since the efforts of global institutions such as IIRC, GRI (Global Reporting Initiative), and domestic regulators focus on the measurement and assurance issues of IR concurrently, theoretical and empirical academic contributions are needed for the encouragement and improvement of these regulations.

The rest of the paper will be organized as follows: First, externalities issues will be defined and covered from the perspective of economic theory.

Then in the third section, CSR and integrated reporting theories; and the interrelations of these theories with the economic theory will be examined and how integrated reporting serves as a tool to the externalities issues will be discussed. Fourth section provides assurance issues of IR and the last section concludes the paper with directions for the future research.

2. ECONOMIC THEORY AND EXTERNALITIES ISSUES

Externalities can be positive and negative in nature. One of the widely used examples of negative externality is environmental pollution caused by businesses.

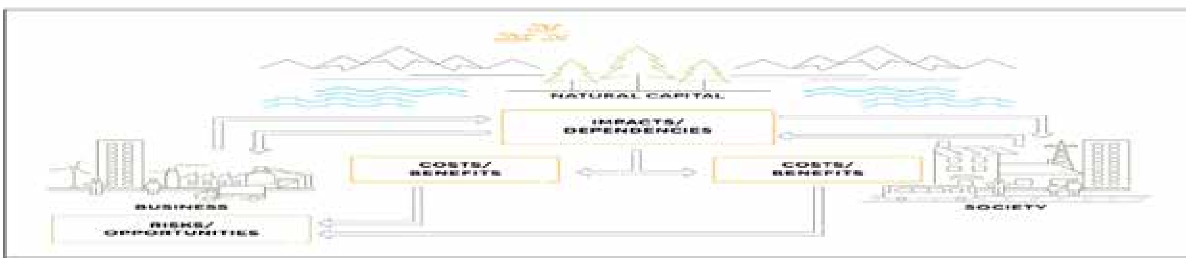

Figure 1. Use of Natural Capital

Source: https://naturalcapitalcoalition.org/natural-capital/

As presented in Figure 1, businesses' impacts and dependencies to the natural capital provide costs and benefits for the businesses and the public that lead to risks and also opportunities. Externalities are the main source of most of the conflicts between businesses and public (Heal, 2005). Externalities are present when all of the costs or benefits of a public good are not fully borne by the market participants for it as an oil refinery may not have to pay for some of the air pollution generated by its production and thus may produce more oil than is economically efficient (Browning and Zupan, 2014).

Coase (1960) noted that the externalities are reciprocal; therefore there is more than one way to address an externality. Coase's (1960) view of "why the firm and not the market" in terms of transaction costs can be interpreted as, at zero transaction costs, markets would find the optimal allocation of resources and that there were no externalities that a fully developed market could not internalize (Marciano, 2011). The assignment of duty or responsibility would be a distributive issue rather than an efficiency issue if it was costless. However, as in the case of global warming, from a utilitarian perspective, the duty should be assigned to the party that would most efficiently mitigate the externality. And firms may be considered as a best party to mitigate the externality, and hence the duty should be assigned to them (Baron, 2009).

CSR literature also considers the two views as; 'business has the resources' and 'let business try' because business has a reservoir of management talent, functional expertise and capital, and because so many others have tried and failed to solve social problems caused by externalities (Davis, 1973).

According to Pigou (1920) the divergence between marginal private costs /benefits and marginal social costs / benefits create what we now call the "externalities" and to correct the market failure, Pigou (1920) proposed Pigouvian tax on those activities that produce negative externalities at a rate equal to those external costs so that the market price will more accurately reflect the total costs and benefits of the activity. This is called internalizing externalities by shifting the burden, or costs, from a negative externality, such as pollution or traffic congestion, from outside to inside. However, internalizing externalities does not always take the form of mandatory taxes. Airline Carbon Offset Programs offers the customers to bear the burden of caused externality voluntarily. Actually one of the arguments in favor of CSR is that it will 'ward off government regulation' (Carroll and Sabahana, 2010). This argument can be viewed as a "pro-acting is better than re-acting" approach for preventing a future government intervention by imposing with self-disciplined standards to meet society's expectations in line with the political cost and the legitimacy theories.

According to the economic theory, the policies to protect the environment could also promote profitability and innovation (Emas, 2015), thus create value. Porter and Van Der Linde (1999) stated that pollution is a sign of inefficient resource use. Thus, win-win opportunities for the environment and economy can be captured through policy improvements which reduce pollution in production processes and argue that competitive advantages rely on the capacity for innovation; and, " by stimulating innovation, strict environmental regulations can actually enhance competitiveness" (Porter & van der Linde 1995, 98).

3. CSR, INTEGRATED REPORTING AND THE EXTERNALITIES

As the aim of sustainable development is the long-term stability of the economy and environment; "governments should require polluting entities to bear the costs of their pollution rather than impose those costs on others or on the environment" (Dernbach J. C. 1998, 58). Thus, government policy should ensure that environmental costs are internalized wherever possible to minimize externalities (Emas, 2015).

CSR and integrated reporting may be viewed as a business response to businesses' failure to account for externalities, and externalities are the core of the business strategy and value creation (Heal, 2005) that may serve to develop sustainable policies.

Thus, from the perspectives of shareholder and the stakeholder theories, firms can create shareholder value and market failures can be corrected by focusing not on "private cost" but "social cost" as a source of value. According to Meyer and Kirby (2010) and Mohammed

(2013) externalities should be "measured" and corporate accountability of externalities should be defined calling for corporate action to learn and thus create value directly throughout the supply chain, by positive engagement in CSR activities (Mohammed, 2013).

Churet et. al. (2014) considers 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 "externalities" on the environment and society. According to the IIRC (2013), integrated reporting promotes the access, use and the degree of dependency of the reporting organization on a variety of social, environmental and economic resources; its relation with capital (understood as consisting of financial, manufactured, intellectual, human, social and relationship, and natural capitals, i.e. including externalities); and the organization's impact upon these different forms of capital (De Villiers et. al. 2014).

However, Flower (2015) criticizes IIRC's proposals by stating that these proposals will have little impact on corporate reporting practice, because of their lack of force. Additionally, according to this view, "timeliness" of disclosed information is decreasing by CSR and Integrated reports, thus to provide timely information to the stakeholders, the future of integrated reports will eventually lead to continuous disclosures, and regulations on these disclosures. Accordingly, Dumay (2016) argues that the focus on integrated reporting should evolve into how an organization discloses what "was previously secret or unknown", so that all stakeholders understand how an organization takes into consideration its ethical, social and environmental impacts.

It can be observed that in the United States as an example, the measurement of externalities is viewed as an element of public disclosure as a part of CSR and integrated reporting. The U.S. Environmental Protection Agency commissioned a report to determine value drivers in companies related to natural, social, and intellectual capital in addition to more traditional financial forms of capital, and to present this information to investors (IEC, 2008) aiming to enable stakeholders to access information on social and environmental negative externalities as pollution, natural resource depletion and human rights abuses, as well as positive externalities such as job creation, community development and cures for diseases (IIRC, 2013). The Securities Exchange Commission (SEC) addressed climate change, board diversity, mine safety, conflict minerals, payments to governments by resource extraction firms and other sustainability topics in "disclosure regulations" (SEC, 2008, De Villiers et al., 2014).

4. INTEGRATED REPORTING AND ASSURANCE

However, although the arguments in the previous section may increase the timeliness of information, there are challenges to assuring integrated reports, thus these challenges would accelerate by the proposed frequent disclosures. An increased complexity in the assurance skill set is needed, potentially requiring multidisciplinary teams that raise concerns for whether the cost of assurance on an integrated report will be disproportionate to the perceived benefits which is considered as the reason that the IIRC did not require, but only encouraged, independent assurance on integrated reports (Simnett and Huggins, 2015).

ACCA (the Association of Chartered Certified Accountants) provided an extensive research on the challenges in integrated reporting assurance in 2015. According to ACCA (2015), solely certain parts of the integrated reports can, currently, be the subject of an assurance engagement; the parts that include only factual disclosures with little or no evaluation by management. Information that is abstract, interpretative, predictive or qualitative is too subjective to be the subject of a limited or reasonable assurance engagement. Thus ACCA (2015) argues that this finding would disappoint the 60% of IIRC consultees who claimed that assurance should cover the whole report.

To make the argument of ACCA more specific, below examples are given from McDonalds, Turkey, 2015 report.

Factual Disclosure example: "Average Hours of Training (All restaurant staff) Breakdown of our Trainings (All restaurant staff) 60% TECHNICAL 40% PERSONAL DEVELOPMENT The average hours of training provided to our employees increased during the reporting period as seen in figure 2. The average time allocated in the restaurant for the professional trainings of a restaurant manager is approximately 158 hours".

Figure 2. Factual Disclosure Example

Source: McDonalds 2015 Annual Report.

On the other hand, abstract, interpretative, predictive or qualitative information example may be the following from the same report: "Equality of Opportunity: Our female and male employees recruited at the same management level are offered identical opportunities. As a part of the mentally disabled program launched in 2006, we employ persons with minor mental disabilities at the McDonald's restaurants."

De Villiers et al. (2014) presents the question of "What mechanisms are most effective in prompting assurance service standard setters to change their standards to accommodate the requirements of integrated reporting?" as a fruitful area for future research.

The answers may be guided with more stakeholder engagement in integrated reporting as according to Stubbs and Higgins (2014), the early adopters were found to exhibit a more holistic approach with more engagement between stakeholders, such as the financial and the sustainability groups.

Stakeholder engagement is defined as "... the process used by an organisation to engage relevant stakeholders for a purpose to achieve accepted outcomes" by AA1000 Stakeholder Engagement Standard, 2011. ACCA (2015) claims that "There are some investors who think they can just sit back and collect dividends and take short-term profits without ever applying their minds to the integrated report. Ironically these are the same people who are demanding the assurance of the reports".

Companies should make sure that they are having the appropriate forms of stakeholder engagement, starting with the preparation of the report itself and using the report as the basis for further engagement, for the reporting to be as effective as possible (Brown and Dillard, 2014). Stakeholders could engage in the preparation of the IR by contributing to the decisions on the relevance and materiality issues.

Thus, the appropriate measurement of externalities and the materiality issues regarding the assurance of the disclosed information does not solely depend on the efforts of the companies, regulators and auditors, but requires the engagement of the internal and external stakeholders.

5. CONCLUSIONS AND DIRECTIONS FOR FUTURE RESEARCH

This paper presents integrated reporting as a tool to help overcome the externalities problems in economic theory. Integrated reports are providing information as public disclosures on the externalities caused/provided by a corporation, and give metrics to measure the impact of externalities to the corporation and to the other related parties. Hence integrated reports serve as a key to address externalities issues, either by improving contractual arrangements or by leading to better regulatory solutions.

However, measuring and disclosing externalities is a difficult challenge that necessitates new multidisciplinary assurance frameworks. Information provided in integrated reports is a very noisy signal of externalities because of measurement and assurance problems and is not timely enough to decrease information asymmetries at the present time. To address the externalities issue, integrated reporting should be improved by better definitions of caused/provided externalities, and consistent measurement techniques throughout different cases. Additionally, strategies to solve assurance and timeliness issues should be generated. Otherwise, the disclosures regarding externalities in CSR and integrated reports would remain opaque, thus fail to serve in decreasing information asymmetries.

The literature review in this study shows that instead of a forward-looking approach where management provide detailed analysis and their own projections, companies would have to focus on reporting factual information and historic information (ACCA, 2015) and stakeholder engagement may be the key to face the challenges regarding the issues of relevance and materiality. Thus, contribute positively to the evaluation of integrated reports to address externalities.

Regulators, corporations and stakeholders should work together to dissolve the challenges with reporting to reach a better solution to the measurement of externalities.

Further research may examine the role of political cost theory on management decisions regarding the integrated reporting disclosure levels and effectiveness of stakeholder engagement techniques on integrated reporting quality. Objective reporting of externalities can be argued to serve as an integrated reporting quality dimension in empirical studies.

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