IAAER

INTERNATIONAL ASSOCIATION FOR ACCOUNTING EDUCATION & RESEARCH

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IIRC Comment Committee for the Consultation Draft of the International <IR> Framework
London

Dear IIRC <IR> Consultation Draft Comment Committee:

In response to the IIRC request for comments on the *Consultation Draft of the International <IR> Framework, Integrated Reporting*, we, the members of the <IR> Consultation Draft Comment Committee of the International Association for Accounting Education & Research (IAAER) are pleased to offer our comments.

The views expressed are those of the authors and do not necessarily reflect a consensus view of the IAAER membership. However, all members of the Executive Committee (EC) and the Consult Council (CC) of the International Association for Accounting Education & Research (IAAER) were requested to provide guidance to inform our comment letter.

The mission of the IAAER is to promote excellence in accounting education and research on a worldwide basis and to maximize the contribution of accounting academics to the development and maintenance of high quality, globally recognized standards of accounting practice.

Our comments are supportive of the IIRC's objective to develop an international framework for Integrated Reporting <IR>, and are delivered with the intent to enhance the acceptability of <IR> worldwide.

We thank you for considering our thoughts and suggestions.

Sincerely,

Joint Chairs <IR> Consultation Draft Comment Committee of IAAER:

Wendy Green
Associate Professor of Accounting
Australian School of Business
University of New South Wales
Sydney **Australia**

Mandy Cheng
Associate Professor of Accounting
Australian School of Business
University of New South Wales
Sydney **Australia**

Other Committee Members:

Pieter Conradie
Program Director: Integrated Reporting
The Albert Luthuli Centre for Responsible Leadership
Faculty of Economic and Management Sciences
University of Pretoria
Hatfield **South Africa**

Noriyuki Konishi
Professor of Accounting
Graduate School of Professional Accountancy
Aoyama Gakuin University
Shibuya-Ku, Tokyo **Japan**

Andrea Romi
Assistant Professor of Accounting
Rawls College of Business
Texas Tech University
Lubbock Texas **USA**

COMMENTS ON CONSULTATION DRAFT OF THE INTERNATIONAL <IR> FRAMEWORK

CHAPTER 1: OVERVIEW

Principles-based requirements

1. Should any additional principle-based requirements be added or should any be eliminated or changed? If so, please explain why.

Comment:

As will be discussed in the rest of this submission, we have reservations with some of the key principles. We therefore propose IIRC to consider modifying or changing some of these principles to reflect our concerns.

Concern:

The proposed framework takes the perspective of financial capital providers. Given that integrated thinking is best served (for all parties) when management answers to multiple stakeholders, rather than a 'silo' focus on the shareholder perspective; and given the extent that other capitals are deemed important enough to include as inputs and outputs of the business model, both creating value and somehow receiving value, the focus on financial capital providers may reduce the impact of <IR> as other stakeholder perspectives and interests are not embedded.

Suggestion:

While we view this perspective as inevitable in producing a workable framework, this view may require further justification and clarification. For example, it may be useful to clarify that the <IR> framework is intended to provide guidance for better *external reporting*, rather than to prescribe the actual *processes* behind the report. Although the framework targets the financial capital provider as the primary audience, it does not suggest that the information gathering process should primarily focus on the perspective of financial capital providers.

Concern:

In addition, we have some concerns with the three ‘exclusion clauses’ of ‘unavailability of reliable data, specific legal prohibitions or competitive harms’ (in particular, the last of the three). These clauses, combined with the stated key audience being the financial capital providers, can potentially result in approved rationalization for organizations to avoid disclosure of activities that are unfavorable to wider stakeholder groups. For example, organizations may argue that certain trade-off decisions between capitals (especially between non-financial capitals, say, appeasing unions by keeping an operation in an environmental sensitive area), may not require disclosure because of its potential to reveal their strategic intent and hence cause competitive harm. We note that ‘strategic non-disclosure’ may not always be intentional; prior research has alerted us to the fact that when managers are faced with difficult decisions, they will

both intentionally and subconsciously seek ways to justify a course of action that is more desirable to themselves, especially if there is an easy justification or if the negative effect is indirect (e.g., Peters and Romi 2013a, 2013b; Moore, Tanlu and Bazerman 2010; Paharia, Kassam, Greene and Bazerman 2009; Festinger 1957). As managers are also known to focus more on short term results even if they are aware of the need for long term-thinking (e.g., Luft and Shields 2009; Farrell, Kadous and Towry 2008), these three exclusion clauses in paragraphs 1.11-1.12 can potentially facilitate undesirable non-disclosures.

Suggestion:

One way IIRC can help overcome this concern is to provide additional guidance on what these three exclusion clauses mean: "legal prohibitions" is clear enough; but what is meant by "unavailability of reliable data" – what is deemed reliable? Is the concept consistent with the definition under IFRS? What is meant by "competitive harm"? What are examples of an acceptable "competitive harm" argument?

Integration with other reports and communications

2. Do you agree with how paragraphs 1.18-1.20 characterize the interaction with other reports and communications?

Comment:

We agree that interactions are necessary; a single integrated report is too limiting (again, especially if the intended audience is the financial capital providers). Further, this will assist in encouraging integrated thinking and holistic decision making.

Concern:

Paragraph 1.20 suggests that one of the ways <IR> builds on other reporting is through the "combined emphasis on…..*and providers of financial capital as the primary audience*." [Italics added]. Given many existing reporting frameworks focus on financial capital providers, these italicised words do not assist in clearly distinguishing the difference between <IR> and other reports.

Suggestion:

There needs to be sufficient emphasis placed on the fact that the integrated report is not intended to replace other reports but instead it should "build on" other reports.

3. If the IIRC were to create an online database of authoritative sources of indicators or measurement methods developed by established reporting standard setters and others, which references should be included?

Comment:

Given that each industry, and indeed each organization, has a unique set of circumstances and strategy, it is not feasible to provide definitive suggestions of indicators or measurement methods. Indeed, it is often argued that indicators that uniquely reflect an organization's operation and strategy are potentially more informative than 'generic' indicators (e.g., Kaplan and Norton 1996). Furthermore, there is a risk of giving legitimacy to problematic indicators.

Suggestion:

It may be useful to encourage specific industries to develop key performance areas of concern (rather than key indicators) and benchmarking exercises to aid their member organizations in their performance measurement. It would also be useful to provide guidance on desirable measurement attributes to consider when choosing key performance indicators. Expansion of the practical examples data on the IIRC web site should also be encouraged. For example, the SASB is developing industry norms in relation to materiality.

Other

4. Please provide any other comments you have about Chapter 1.

Suggestion:

In explaining the importance of value creation in the short, medium and long term, it would be worthwhile to re-emphasize that even though financial capital holders are the key audience, organizations are encouraged to discuss how value is also created in other ways for other stakeholders. For example, value can be created when other capitals benefit (e.g. conservation), at the expense of financial capitals. Firms should be encouraged to disclose and explain how this type of value may provide social returns for stakeholders.

CHAPTER 2: FUNDAMENTAL CONCEPTS

The capitals (Section 2B)

5. Do you agree with this approach to the capitals [The capitals – Section 2B]? Why/why not?

Comment:

Overall, the capitals approach to the framework provides a good "completeness" check for the content of an integrated report.

Concern:

Paragraph 2.18, suggests that in some cases organizations' interaction with some of the capitals may be "immaterial" for the purpose of <IR>. This paragraph introduces subjectivity and may lead to an organization ignoring certain capitals. As will be discussed further, the ambiguous concept of materiality (especially when defined from the perspective of financial capital providers) can result in inappropriate non-disclosure.

Suggestion:

An "apply or otherwise explain why not" approach to the capitals would be beneficial in two ways: first it would force reporters to consider whether they have addressed all of the capitals in their reports; and second, it will reduce discretion with respect to "immaterial" items leading to non-disclosure.

6. Please provide any other comments you have about Section 2B?

Comment:

The requirement to explain trade-offs that influence value creation over time, and the examples provided in paragraph 2.25 will be beneficial in increasing the likelihood of long term thinking. It also allows companies to justify difficult trade-offs.

Concern:

With respect to 2.16, further clarifications with regard to "overall stock of capitals" would be helpful. Given that the target audience of an integrated report is financial capital providers, and that 2.16 acknowledges that "whether the net effect is an increase or decrease will depend on the perspective taken", the combined effect might be that "overall stock of capital" will primarily focus on financial capital. For example, from the perspective of financial capital providers, a trade-off between natural capital and financial capital can easily be interpreted as an "overall increase in capitals" if the positive impact on profit is significant. Further, some of the capitals are more difficult to measure, making it easier to justify an overall increase (e.g., it might be that only simple narrative is sufficient to justify an increase in social and relationship capital by referring to improved "shared norms, and common values and behaviors"). Evidence of such behaviour can be found in the accounting literature describing the self-serving disclosure

concerning legitimation tactics directed at aligning the firm's norms and values with that of the larger society (e.g., Patten, 1991, 1992, 1995, 2005; Cho and Patten 2007).

Suggestion:

To avoid self-serving disclosure (see also comments to Question 1), further guidance on the concept of "overall stock of capital" is important.

Concern:

With respect to paragraph 2.22, the concepts of "availability" and "affordability" require more clarification. Availability and affordability appear to be similar concepts: if a capital is low in availability, it is probably low in affordability, also. For example, consider the natural capital of old growth forests. They are not highly available (limited supplies), and therefore one would argue that the providers of this capital (the eco-system) will consider this resource not affordable. Unless you take the perspective of the primary audience, the financial capital provider, who can potentially consider this resource affordable if the organization can find a low cost way of harvesting.

Suggestion:

One framework that has been used effectively for intangible assets is Sveiby's (1997) framework on intangible asset monitor. Sveiby suggests identifying measures on (i) growth and renewal, (ii) stability and (iii) efficiency. Applying these concepts to the current context, three useful aspects of measuring capitals might be growth (are there any actions taken to grow this capital?), availability/affordability, and quality (do these capitals enable value creation?).

Business Model (Section 2C)

7. Do you agree with this definition? [2.26] Why/why not?

Comment:

Yes, this definition is reasonable.

Suggestion:

It might be helpful to also include a statement of vision and value – the purpose of the organization. A statement of vision and value helps investors understand the rationale behind its subsequence choices (e.g., the trade-offs of various capitals over time). Disclosure of the reporting boundary may also be appropriate.

8. Do you agree with this definition? [2.35-2.36] Why/why not?

Comment:

Yes, this definition is very inclusive, covering internal and external, positive and negative consequences. The discussions in paragraphs 2.28 (relating to how important it is to explain the security, availability, quality and affordability of the components of natural capital) and 2.35 (relating to the outcomes being defined as the internal and external consequences - positive and negative - for the capitals as a result of a firm's business activities and outputs) are particularly useful. Further, including externalities highlights the broader responsibilities of companies, and is an improvement over the narrow focus in past reporting frameworks.

9. Please provide any other comments you have about Section 2C or the disclosure requirements and related guidance regarding business models contained in the Content Elements Chapter of the Framework (see Section 4E)?

We do not have any additional comments.

Other

10. Please provide any other comments you have about Chapter 2 that are not already addressed by your responses above.

Concern:

Overall, we reiterate our concern that, because the integrated report's primary audience is the financial capital providers, this may lead organizations to continue to place greater burdens on other stakeholders despite the claim in paragraph 2.9 that "the organization and society therefore share both the cost of the capital used as inputs and the value created by the organization." That is, oftentimes the cost of capital comes mainly from society but the value created is mostly restricted to financial capital providers.

With respect to paragraph 2.39, it is not clear how <IR> supports "broader societal interests by encouraging the allocation of financial capital to reward and support long term, as well as the short and medium term, value creation within planetary limits and societal expectations". This statement needs greater clarification. There is no clear provision to say that value is being created within any limits, unless management decides those "limits" are material, in an important capital that they choose to report on, and are willing to discuss negatives or risks associated with such limits.

Suggestion:

Perhaps there is a need to improve clarity around these issues by tying the discussion back to the concepts of availability and affordability.

Concern:

With respect to paragraph 2.40, although it indicates that <IR> is based on an understanding that future cash flows are dependent on a wider range of capitals, firms are not, at any point, asked to be truly accountable to those capitals.

Suggestion:

If value creation is dependent on other capitals, as the framework claims, then paragraph 2.42 should more clearly explain why <IR> is not requiring value measurement for each capital.

Concern:

Accounting research indicates users are not able to garner a true assessment of non-financial performance based on firm disclosures, which raises the question, what really is <IR> offering in the way of additional information to report (e.g. Gray et al., 1995; Guthrie and Parker, 1989; Cho and Patten, 2007; Patten, 1991, 1992, 1995, 2005; Walden and Schwartz, 1997; Brown and Deegan, 1998; O'Donovan, 2002; Deegan et al., 2002; Bansal and Clelland, 2004)

CHAPTER 3: GUIDING PRINCIPLES

Materiality and conciseness (Section 3D)

11. Do you agree with this approach to materiality? If not, how would you change it?

Concern:

The definition of materiality presented in paragraph 3.23 rests on an item being able to “substantively influence” the “primary intended report users”, (which the first sections of the framework identify to be those supplying financial capital). We identify three concerns with this approach.

First, materiality should not be limited to financial capitals else the reporting will be skewed to items creating a financial return/impact on the financial capital. Materiality depends on both quantitative and qualitative factors: a matter may be material due to its nature or its size.

Second, this is a report-driven rather reporting process materiality approach. In fact the framework does not address materiality in terms of the process of creating the report, but only in terms of the report itself. Even if the issues that the organization chooses to report are those that are material to investors, this should not mean that the underlying reporting processes should be unduly skewed to favor investors, since this would not be in the best interest of the organizations ability to create value in the short medium and longer term. Please also see comments to Question 1.

Finally, although paragraph 3.26 notes a firm should include negative matters voluntarily in this report, accounting research has shown that firms will disregard reporting requirements if they feel the information may harm stock prices, thus they may be less inclined to follow such a mandate (Peters and Romi 2013a). Further, the audit function also does not fully support the completeness assertion of the disclosures.

Suggestion:

During the integrated reporting process, the materiality of an item should be considered purely on its relevance to affect the organizations ability to create value in the short, medium and long term. At this point the source of the item is not relevant, it can come from any stakeholder group; the individual circumstances of the entity will dictate what is relevant in terms of the value creations process.

It is recognized that it would be impossible to cater to the perspectives of all stakeholders, thus one group of intended users will take precedence. That said, if the intended users are short term investors, then changes to some of the capitals may not be seen as material. Thus we suggest that an additional clause be added to read: “substantively affect the assessment of a provider of capital of their intention to continue to provide capital to the company.”

Concern:

It is stated that materiality depends on both *relevance* and *importance*; and *importance* in turn refers to the *nature* and *magnitude* of the matter (see footnote 5 on p.21 of the Consultative Draft). However, in 5B, *importance* is more explicitly defined as a combination of the *magnitude* and *likelihood* (not nature) of the matter. This could potentially create some confusion. Further, it is not clear from the guidelines how one can assess the magnitude/nature of matters, especially in relation to social matters.

Suggestion:

It will be useful for the <IR> Framework to provide guidance on the social indicators of importance (e.g. GRI guidelines and ISO26000).

Either best practice consensus within industries may assist in this process, or a number of exemplar KPIs (KRIs) which combine quantitative information with qualitative information could be provided by the <IR> Framework. This will allow comparison of KPIs that are consistent over time and in a way that enables comparison with other organizations to the extent it is material to the organization's own value creation story.

12. Please provide any other comments you have about Section 3D or the Materiality determination process (Section 5B).

Concern:

Paragraph 3.27 suggests that materiality assessment is to be integrated to "everyday management". This seems to suggest a need for continuous assessments which may be perceived as quite a burden.

Suggestion:

The guidelines provided by GRI and ISO26000 may assist in prioritizing social indicators that may be considered material.

Reliability and completeness (Section 3E)

13. How should the reliability of an integrated report be demonstrated?

Comment:

A highly reliable integrated reporting process involves a circular process: the indicators that the organization uses to measure its strategic performance are subject to a robust materiality determination process; the information that is fed into the materiality determination process is subject to a robust stakeholder engagement process; and a robust stakeholder engagement process would be subject to a comprehensive understanding of the entities business model and its

value chain, as well as the internal and external operating environment. The connectivity of these different elements of the integrated reporting process is thus compulsory to gauge reliability. The factual correctness of any piece of information in the integrated report is subject to the connectivity principle; otherwise the relevance thereof cannot be illustrated.

Completeness is not addressed within this question, but remains a key element of report reliability.

Suggestion:

The IASB and the FASB consider relevance to be more important than reliability, suggesting that reliability may not be the most critical consideration under <IR>. Further, the reliability of any report rests in the integrity of the report preparers. External assurance would provide the highest level of reliability for an integrated report. Some reliability may also be inferred via disclosure of processes used by management to ensure the report is reliable. The user can then decide if this process is reasonable.

Comment:

Paragraph 5.21 mentions that “the framework provides reporting criteria against which organizations and assurance providers assess a reports adherence”.

This creates the impression that the framework will yield appropriate subject matter that can be subjected to criteria from assurance providers, however the framework is silent on what appropriate subject matter will look like. Industry norms and best practice are still being developed. It is thus a challenge to understand exactly what appropriate subject matter will look like.

Suggestion:

The value of assurance and the nature of appropriate subject matter that is suitable for assurance could be further addressed in the framework. Report preparers should be encouraged to prepare reports as though it will be subject to external assurance. This will mean that an audit trail should be maintained for information that is being presented in the integrated report as far as possible. More importantly, where reporting organizations endeavor to develop disclosures that are not covered within an existing industry framework, the management assumptions that underlie these disclosures should be developed with an understanding of what appropriate subject matter looks like. Should this subject matter then be subject to assurance, the management assumptions will assist assurance providers to develop suitable criteria to assure these disclosures. It will thus greatly assist reporting organizations to understand what appropriate subject matter looks like, and what the attributes of suitable criteria looks like.

14. Please provide any other comments you have about Section 3E.

Comment:

No guidance is provided to assist in assessing what an acceptably low level of freedom from material bias would be.

Other

15. Please provide any other comments you have about Chapter 3 that are not already addressed by your responses above

Comment:

The discussion in paragraph 3.16 relating to the need to understand, incorporate, and respond to key stakeholders' legitimate needs, interests and expectations is useful.

To the extent the framework is applied, at a minimum, <IR> will centralize information firms already report/misreport in a disaggregated fashion, however the extent to which <IR> enhances transparency and accountability will be a function of management integrity.

CHAPTER 4: CONTENT ELEMENTS

16. Please provide any comments you have about Chapter 4 that are not already addressed by your responses above (please include comments on the Content Element Business Model [Section 4E] in your answer to questions 7-9 above rather than here).

Comment:

The principle based approach to reporting information about an organization’s risks could result in a “boilerplate” disclosure tactic and potentially lead to a lack of completeness (see also comments to Question 5).

CHAPTER 5: PREPARATION AND PRESENTATION

Involvement of those charged with governance (Section 5D)

17. Should there be a requirement for those charged with governance to include a statement acknowledging their responsibility for the integrated report? Why/why not?

Concern:

The experience in South Africa suggests that without high-level buy-in integrated reporting can become a somewhat academic exercise (Deloitte 2012).

Suggestion:

Buy-in may be enhanced by an alignment between executive remuneration and strategic objectives outlined in the <IR> framework.

Consider a requirement to include an acknowledgement that the processes employed in preparing the integrated report are reasonable, rather than focus only on the outcomes. In addition, since an internal audit may enhance/be perceived to enhance the integrated report reliability this process should also be disclosed.

18. Please provide any other comments you have about involvement of those charged with governance (Section 5D).

Comment:

Research indicates that firm's with governance bodies assigned to particular reporting subjects (e.g. environmental) do render greater reporting quality about that information (Peters and Romi 2013b).

Credibility (Section 5E)

19. If assurance is to be obtained, should it cover the integrated report as a whole, or specific aspects of the report? Why?

Comment:

Due to the amount of discretion allowed in this reporting framework we believe that external and independent assurance should be required to provide credibility to the integrated report.

This assurance should extend to the entire report given that whole <IR> concept is about connectivity. Also, report users may not distinguish between the information that is assured and the information that is not assured. It may be that investors will assume the whole report is

already verified even if only one part is. It will also be difficult to assure the integrated report without assuring the underlying process.

The level of assurance is debatable. An alternative would be independent assurance of process compliance – i.e. that the company has a system in place that can ensure integrity (e.g. ISO 9000)

20. Please provide any other comments you have about Credibility (Section 5E).

Assurance providers are particularly asked to comment on whether they consider the Framework provides suitable criteria for an assurance engagement.

No comments.

Other

21. Please provide any other comments you have about Chapter 5 that are not already addressed by your responses above (please include comments on the materiality determination process [Section 5B] in your answer to question 11 above rather than here).

Suggestions:

In assessing importance, it may be beneficial to comment on the need to consider the company's risk appetite (i.e. its willingness to tolerate risks in pursuit of returns).

Also, the materiality assessment is geared towards future events (past and current events have 100% likelihood of occurrence since they have already occurred). Perhaps other dimensions can be discussed; e.g., current impact vs. length of impact (if current impact is small but it will have long term implications it may still be important; if high on both dimensions it is definitely important; if low on both dimensions it is not important).

Overall view

22. Recognizing that <IR> will evolve over time, please explain the extent to which you believe the content of the Framework overall is appropriate for use by organizations in preparing an integrated report and for providing report users with information about an organization's ability to create value in the short, medium and long term?

Comment:

The overall approach to reporting is appropriate. The inclusion of capitals, the discussion of risks and opportunities associated with short, medium and long-term success, etc. are all commendable reporting practices.

Concern:

The shortcoming of the <IR> framework is found in the principles-based approach that allows management significant discretion in reporting. More rules and specific requirements and examples would be a better approach in the initial stages of this reporting framework development. It is hoped that over time, as indicators, measurements, and societal expectations evolve, the reporting practices will follow.

Without clear guidelines and top executive buy-in, there is a risk that this framework will not provide any information to users about an organization's ability to create value in any term, beyond what is already available. This belief is not because the information requested is not valuable, it is based on the belief that organizations will not provide the information as requested.

Paragraph 1.8 suggests that long term investors' interests are aligned with other stakeholders as long term investors want long term value creation. This view can potentially be challenged by considering recent worldwide financial events and crises.

Development of <IR>

23. If the IIRC were to develop explanatory material on <IR> in addition to the Framework, which three topics would you recommend be given priority? Why?

The audience; the capital inclusions; and materiality.

The audience: Per previous discussions, the primary audience being financial capital providers limits a firm's accountability, limits a firm's vantage point on what creates or destroys value, and does not render anything beyond what we presently have in public financial reports.

The capitals: All firms should have to include information for all capitals. It is true that some will be more important for some firms than others, but firms should have to disclose why they are not considering a specific capital in relation to inputs, operations, and outputs.

The materiality: The materiality section needs improvement. Materiality has traditionally been based on inclusion of information that may make a difference in the decisions made by users, and we still see management continuously (and predictably for negative information) not include items based on self-serving motives. The definition of materiality should consider ways of reflecting management's motivation to withhold harmful, but indeed important information.

Other

24. Please provide any other comments not already addressed by your responses to Questions 1-23.

About forty listed Japanese companies have already prepared integrated reports. Many companies state that integrated reporting will enhance corporate management through (1) better managerial training, (2) better risk management, and (3) improved accountability of management, investor protection and the meaningfulness of financial statements.

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