IIRC & KIRCHHOFF
INVESTOR RESEARCH REPORT

Closing the gap: The role of integrated reporting in communicating a company's value creation to investors

10 YEARS OF INTEGRATED REPORTING ‹IR›

KIRCHHOFF

Contents

Foreword

Integrated reporting is an important development in the evolution of corporate reporting. Its roots can be traced back to the first King Report on Corporate Governance, published in South Africa in 1994, the year that Nelson Mandela was elected President. The King Report responded to the need to rebuild trust with investors, as well as other key stakeholders, after mass disinvestment had helped to bring an end to the apartheid era.

Building and maintaining trust with investors remains a key goal of corporate reporting. In today's world, this cannot be achieved by disclosing financial performance alone. Investors increasingly appreciate the linkage between company performance on a range of environmental, social and governance factors and their ability to deliver profits over the longer term. Integrated reporting provides a framework that companies can use to provide investors with the information they need to make better investment decisions. By reporting consistently under the International <IR> Framework over successive years, companies can help investors to understand the risks and opportunities they face and generate greater trust in their potential performance.

In Germany, uptake of integrated reporting to date has been relatively limited. A few high-profile companies have blazed a trail, but the majority have failed to follow. However, an important feature of the reporting landscape in Germany is the Lagebericht – the management report that medium-sized and large companies are required to prepare. This management report provides an appropriate view of the course of business and the position of the company. Alongside the financial statements, it is an important element of most companies' annual reports.

Given the existing requirements for the Lagebericht, for many German companies the step up to producing an integrated report would not be too great. The management report must, for example, contain certain content elements, including the most important financial and (for large companies) non-financial performance indicators, an explanation of the company's expected development and significant risks and opportunities. These could equally be contained in an integrated report that encourages the integration of financial and non-financial information in a clear and coherent way.

Therefore, the foundations for enhanced reporting under the <IR> Framework are already in place. We encourage companies not only in Germany but around the world to explore the potential benefits of integrated reporting, if they are not already doing so.

Corporate reporting continues to evolve. Future developments are likely, given the cooperation now taking place between five global organizations involved in corporate reporting and sustainability standards, including the International Integrated Reporting Council (IIRC). These organizations are coming together with a shared goal to achieve global consistency in reporting. As one of the first steps in this regards, the IIRC and the Sustainability Accounting Standards Board (SASB) recently announced their intention to merge in 2021 into a unified organization, the Value Reporting Foundation. The Value Reporting Foundation will maintain the Integrated Reporting Framework, advocate integrated thinking, and set sustainability disclosure standards for enterprise value creation. Both companies and investors stand to benefit.

By Charles Tilley and Klaus Kirchhoff

Executive summary

This report explores the extent to which investors and analysts value non-financial information, the various ways they use it and the benefits they see from integrated reporting. It also considers how to stimulate increased reporting of non-financial information in an integrated way. Although based on interviews with members of the investment community in Germany, the research has insights relevant to companies and investors internationally.

While the IIRC and Kirchhoff Consult AG share the view that the term "non-financial" is misleading, we have used the term in this report as it remains the prevailing terminology currently used by many investors globally. Our research finds that investors and analysts of all types value non-financial information that ultimately translates into financial impacts and metrics. They see this non-financial information as covering many areas of interest, including companies' governance frameworks, their relationships with employees and wider society, and their environmental impacts. Investors and analysts also want to know about business models, strategy and market trends.

Integrated reporting focuses not only on financial, environmental and social value drivers but also the key areas of intangible value, such as intellectual capital and human capital, and tangible value, such as manufactured capital and the growing need to address global infrastructure gaps.

This research focuses on a subset of the six broad value drivers included in the <IR> Framework: natural, human, and social and relationship capital. These three capitals can be directly linked to the commonly used language of ESG (environmental, social and governance) reporting, which is a focus of this research given recent progress and developments in this space.

MULTIPLE USES AND SOURCES

Investors and analysts use non-financial information in many ways – from screening companies in or out of portfolios, through to estimating company valuations. In doing so, they make judgements about future cash flows and the risks companies face, for example by adjusting the classic discounted cash flow (DCF) model accordingly.

Third-party databases and company reports, as well as a direct dialogue with the companies, are all considered useful sources of non-financial information, particularly on core aspects of environmental, social and governance (ESG) performance. However, managers of large portfolios inevitably rely more on databases and ratings agencies due to time constraints. More targeted investors are willing to take the time to read material that companies produce themselves, particularly annual reports, but also additional sustainability and other relevant reports. Other sources, including sector reports and websites, are also often used to gain a more complete picture of a company and the market in which it operates.

CHALLENGES AND REQUIREMENTS

Non-financial information can have some weaknesses. The data companies report can be subjective and is not always comparable. There is often a lack of linkage between the non-financial and financial content of company reports.

What investors and analysts want is non-financial information that is material, relevant, reliable, comparable and consistent over time. They also look for connectivity between all the different elements of a corporate report – a coherence in the story companies tell. Most of all, investors look for connectivity of the non-financial information with the financials.

For this reason, integrated reporting can help to provide investors with the information they need, in a useful format that links non-financial and financial impacts and outcomes. They appreciate the centrality of the business model and multiple capitals in the <IR> Framework, which allows them to fully understand the company's value creation. Investors and analysts also value the connectivity, long-term focus and integrated thinking that results from adopting integrated reporting.

LEVERS FOR ENHANCED REPORTING

If investors would like to see more reporting of this nature, how could it be encouraged? Investor pressure is essential. Regulation could also play a part, although some interviewees have concerns that mandatory reporting requirements can result in less relevant disclosures. Quantity may increase, while quality decreases. Similarly, if regulations require funds identified as "green" or "sustainable" to meet certain criteria, some providers may be deterred from offering ESG-focused products. Further development of global standards might also stimulate increased reporting, but again some investors fear that standardization can result in some loss of richness and the unique nature of the information companies disclose. Although current regulations in Germany have improved corporate reporting, there is still much opportunity for further development.

On the international stage, progress is being made towards a reformed corporate reporting system that gives equal weight to financial and non-financial information. Such work recognizes the need to fill the information gap created by traditional financial statements that place relatively little emphasis on the intangible assets that now underpin market values.

Integrated reporting is a well-established mechanism for linking the financial and non-financial information that companies report across the six capitals identified in the <IR> Framework. Although many entities around the world are now applying the principles of integrated reporting, take-up in Germany has been relatively limited – hence the focus on Germany in this research report. Our findings encourage us to assume that, if embraced by more companies across the world, integrated reporting could make a significant contribution towards closing the current information gap and meeting the needs of a wide range of investors.

The imperative

For many years, the relationship between a company's book value and market value has been weakening. The gap between the two is now extreme. According to research by Ocean Tomo in July 2020, intangible assets account for over 90% of market value among S&P 500 companies. [1] This compares to 17% in 1975.

The increasing dominance of intangible assets is also seen in the European arena. Based on companies in the S&P Europe 350 Index, intangible assets now account for 74% of market value (up three percentage points in the last five years).

As a result, although traditional financial and accounting metrics are still vital, they do not provide a sufficient explanation of the company's value as determined by the market – and how it could change in future.

This creates particular challenges for investors and analysts. How can they estimate a company's future value? How can they understand the risks that could erode the intangible assets underpinning that value?

AN EVOLVING LANDSCAPE

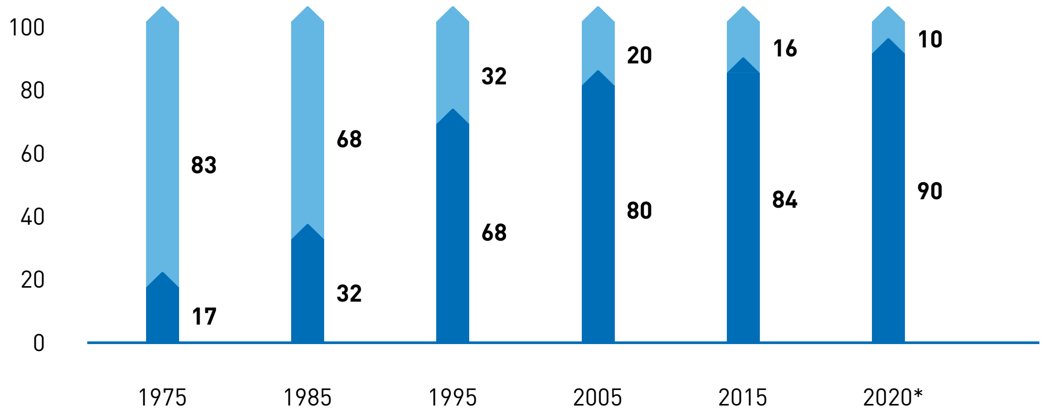
At the same time, the social and regulatory environment in which companies operate keeps evolving. Society, governments and regulators see the need to encourage or enforce behavior that minimizes harm to both people and planet, while still encouraging profitable businesses.

From a global perspective, the United Nation's Sustainable Development Goals (SDGs), agreed in 2015, provide a blueprint to achieve a better and more sustainable future for all.

Regional initiatives are also having an impact. In the US, for example, President-Elect Joe Biden has outlined a plan for a Clean Energy Revolution and believes the Green New Deal is a crucial framework for meeting climate challenges. The Biden Plan includes ensuring the US achieves a 100% clean energy economy and reaches net-zero emissions no later than 2050. Climate change will be fully integrated into national, foreign and trade policies.

COMPONENTS OF S&P 500 MARKET VALUE

IN % **TANGIBLE ASSETS** **INTANGIBLE ASSETS**



Source: Ocean Tomo, LLC intangible asset market value study, 2020
*Interim study update as of 1 July 2020.

The European Green Deal, which aims to make the EU's economy sustainable, provides an action plan to boost the efficient use of resources by moving to a clean, circular economy, while also restoring biodiversity and cutting pollution.

High-level ambitions are gradually being translated into frameworks that companies can apply. Work is ongoing to develop the EU Taxonomy – a tool to help investors and companies navigate the transition to a low-carbon, resilient and resource-efficient economy. The goal is to create a common framework to enable investors to assess how effectively companies are delivering against environmental and social criteria in particular.

Such initiatives and frameworks are important for stimulating additional reporting by companies on a range of sustainability issues. However, companies still face the challenge of presenting this information in a coherent and connected way. How can they convey the link between their investment in low-carbon assets and their income potential? How can they explain how investing in their workforce feeds through into increased revenues?

THE VALUE OF INTEGRATED REPORTING

One solution lies with the adoption of integrated reporting as developed by the International Integrated Reporting Council (IIRC). The IIRC's International <IR> Framework, released in 2013, with minor revisions to the Framework being published in January 2021, identifies six capitals that organizations depend on to varying degrees for their success: financial, manufactured, intellectual, human, social and relationship, and natural. It identifies guiding principles that underpin the preparation of an integrated report and its content, such as strategic focus and future orientation, connectivity of information, materiality, consistency and comparability. The <IR> Framework also identifies the expected content of an integrated report, including information on governance, the business model, risks and opportunities, strategy and resource allocation.

In essence, an integrated report is intended to communicate 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. Its approach can therefore help to connect financial and non-financial information.

However, although more than two thousand entities around the world are now applying the principles of integrated reporting, take-up in Germany has been relatively limited. Only a handful of companies explicitly report under the <IR> Framework. On a positive note, while the number of integrated reports produced in Germany is relatively low, the quality is "excellent", according to recent research. [2]

JOINT RESEARCH

Inspired by the desire to understand the extent to which investors and analysts in Germany do value and use non-financial information, the IIRC and Kirchhoff decided to undertake a joint research project. Its goals included exploring whether investors would welcome the wider adoption of integrated reporting and what levers could be pulled to achieve it.

Although this research is based primarily on German investors, the findings are relevant to both companies and investors across Europe and the world. They focus attention on the information gap that currently exists in terms of explaining and understanding companies' market value. They also give insights into how companies can provide investors and analysts with information they value, in a form they can use most easily.

Methodology

We interviewed 12 individuals in German-speaking countries (11 based in Germany and one in Switzerland). These interviewees have a range of roles. They include sell-side and buy-side investors and analysts and risk management specialists. We interviewed representatives from large financial institutions with a global reach, family offices, and investment and valuation consultancies. Some interviewees have a mainstream investment focus, while others have a particular interest in ESG areas or a focus on impact investing.

All interviews followed a similar structure, covering issues such as:

- Types of non-financial information investors and analysts use
- How they use non-financial information
- Sources of non-financial information
- Desirable qualities of non-financial information
- Features of integrated reporting that investors find useful
- Levers that could encourage increased reporting of non-financial information in an integrated way
- The impact of regulation so far on reporting practices.

The core questions used to guide these discussions are included in Appendix 1. However, we allowed conversations to flow freely, guided by individuals' experience and interests.

What is non-financial information?

Non-financial information is information that does not currently appear in a company's financial statements – its profit and loss account (P&L), balance sheet or cash flow statement. However, it provides insight into the potential future financial performance or value of a company.

Alternative terms include "extra-financial", referring to the fact the information is not included in conventional financial statements, or "pre-financial", emphasizing the fact that these factors ultimately have an impact on the financial performance of the company – its cash flows, P&L and balance sheet.

Non-financial information may be purely qualitative, expressed in text, such as a description of the qualifications and experience of a management team. It may also be subjective, e.g. when companies report on how they are positioned in a market. However, it can also be quantitative and objective, e.g. the number of insurance claims received by an insurer year on year, or market share statistics.

Some investors have moral or ethical standards that guide their investment activity. For example, they may not want to invest in defence companies because they have a moral objection to the ultimate uses of their products. Impact investors may have investment goals that place as much emphasis on tackling climate change as on delivering profits. However, for typical mainstream investors, the value of non-financial information does not depend on any ethical or moral viewpoint but on the extent that it increases insight into a company's risks, future performance potential and current valuation.

One business valuation expert uses the example of environmental pollution, whereby polluters run the risk of financial penalties. He says: "Irrespective of whether we think this [pollution] is good or bad, it is a question of valuation and financial risk alone."

BUSINESS VALUATION CONSULTANT

"Relevant non-financial information is that which may not be financial at the moment, but which may become financial in the future."

HEAD OF MUTUAL FUNDS

"With non-financial KPIs, you always have a purpose or goal that you are pursuing. In addition, it is interesting to determine a financial reference value from the non-financial information. It can be an enabler for determining a financial figure."

EQUITY ANALYST

"In the end it is only the financials that are interesting – or the future financials... the profit or turnover in ten years, 15 years, 20 years or in one year. But in order to estimate that, the non-financial figures are the decisive factor."

What types of non-financial information do investors value?

Investors and analysts use many different types of non-financial information in their daily activities.

BUSINESS MODEL, STRATEGY AND MARKET TRENDS

Information related to a company's business model and strategy, as well as market trends that could affect the organization, are considered useful forms of non-financial information. When considering market factors, key non-financial performance indicators are established for each sector, with individual company performance assessed against those KPIs over time.

One equity investor comments: "We spent a very, very long time on the business model... The business model, the environment, the products and services were crucial for us." If the story did not add up, there would be no investment.

From a strategic perspective, investors want to understand how a business is positioning itself, e.g. as a niche player, cost leader or whether it has some other form of differentiation. The competitive environment and market trends are also of great interest e.g. what impact might be felt from technological developments and digitization.

GOVERNANCE

Some investors have been considering governance issues as an important part of their fiduciary responsibility since the 1990s. Aspects of governance considered important forms of non-financial information include:

- The quality of the board and its independence
- Remuneration systems – including whether these take account of ESG factors and have a short-term or long-term focus
- Related-party transactions
- Auditors and audit-related issues
- Shareholder voting rights
- Court cases against the company
- Any indications of bribery or corruption
- Any indication of reliance on illegal migrants
- Human rights violations in the supply chain.

In terms of the quality of the management and supervisory boards, investors will look at the board members' backgrounds, what they have done in the past, what they stand for and any indicators to measure past performance.

Understanding what motivates the management team is seen as valuable. One early stage impact investor says: "Nobody works around the clock for money only. After three decades of investment and entrepreneurship experience, I know that only your passion and purpose will pull you through tough times, not the financial incentive."

A change of management could be an indicator not only of future earnings potential but also future ESG performance potential. As a senior analyst says: "You will not only have an earnings momentum in the classic sense, but also an ESG momentum."

Company ownership structures are also of interest, for example, whether there is a dominant major shareholder who is also represented in the management team or on the supervisory board. Such a dominant shareholder may restrict the ability of other shareholders to influence management decisions. The incentives driving decisions may also differ from those in a company owned by "anonymous investors" with relatively little connection to it, one equity analyst notes.

Some investors and analysts include corporate culture under the governance heading. "Corporate culture is an extremely strong governance mechanism," says a business valuation consultant. Companies with strong corporate cultures are better able to address problems quickly. "This is a form of risk management, because we as company valuers, as investors, must look to the future... Even if the question of corporate culture does not make our point forecast any better, it makes it more stable in a sense because it represents a certain downside protection."

Assessing corporate culture is not straightforward. For example, as one investor notes, employee surveys may give some insight into corporate culture, but can be distorted, depending on participation rates and whether staff of all levels of satisfaction take part.

IMPACT INVESTOR

"80% of the risk in early stage investing or entrepreneurship lies with the founders' team."

SOCIAL FACTORS

Social information of interest to investors and analysts includes insights linked to internal stakeholders. For example, investors look at information on employees, such as numbers of employee fatalities and accidents, and rates of employee absenteeism. Staff turnover rates are widely considered. This could be particularly relevant in consulting businesses, where employees build up valuable knowledge and experience over time and where high staff churn could indicate a risk to the business model. If it becomes harder to recruit replacements, the business model could again be at risk.

One equity analyst explains the importance of considering social factors when evaluating a mining company. Gaining the buy-in of the local population (through employment and local investment) may incur costs, but could reduce the risks of opposition and riots, including attempts to appropriate the mine. He is therefore interested in various factors: "How many employees are local? Are schools or infrastructure being built? How long term is the approach or is as much as possible taken out quickly? In my opinion, behavior beyond the financial ratios naturally has an immense influence on the value of the company."

External stakeholders such as customers are also of interest, for example, whether there have been any issues with product safety or the need for product recalls. So too are any changes in regulation that may have an impact on a company's business model and competitive position. Health and safety is also a topic covered in the "social" category.

ENVIRONMENT

Interest in environmental non-financial information is strong, reflecting factors such as increasing regulation to tackle climate change and concerns about water shortages. These are topics that many mainstream investors consider, as well as impact investors with a particular focus on climate change.

Analysts and investors are interested in details such as CO_2 emissions and water consumption, although they interpret them in a sector context. For example, they see little point in an internet company disclosing water consumption.

VALUE CHAIN

One mainstream mutual funds investor notes that rather than individually, companies are analyzed in the context of their market environment and value chain. For example, one investor knows to the nearest ton the CO_2 footprint (using the equity ownership methodology) for all his funds. However, he believes it important to also consider the impact of the footprint elsewhere in the value chain, where companies can be held accountable for it.

ESG INTEGRATION SPECIALIST AND FORMER ANALYST

"On the environmental side, we look at large blocks of topics such as the efficiency of the company in the use of raw materials. How clean is the company? Are there emissions? What is done with wastewater? Are there spills? Then there are topics on the energy side and the company's exposure to green innovation. What products or services does the company sell? Does it help other industries to reduce their impact on the environment?"

Uses of non-financial information

Investors and analysts use non-financial information extensively and in a variety of ways when making investment decisions, from pre-selecting a range of potential investments to estimating company values.

SCREENING

Non-financial information is used to determine the "investment universe" from which companies will be selected for an individual client's portfolio or a mutual fund. Investors can screen out companies that do not meet certain criteria or clearly defined hurdles related to ESG topics. They also raise "red flags" relating to existing investee companies if some new issue occurs. Equally, some investors may be looking for "best-in-class" investments as assessed against various ESG benchmarks.

The criteria used may relate to simple facts, e.g. that an investee company must not be involved in arms trading, the betting industry or online gaming. There could be a threshold for the frequency of workplace accidents. There may be human rights requirements.

ESG funds in particular have specific standards that need to be met. These could be linked to global standards and initiatives, such as the UN Global Compact. If there is a violation, the company will simply be excluded. A senior analyst at a leading asset manager says: "There is simply no money then, neither on the equity nor on the fixed income side. Not from us and not from many others."

Similarly, a head of sustainability and corporate governance at a major investment firm says: "Every portfolio has a dedicated sustainability policy, a set of sustainable rules. In principle, there are minimum thresholds that companies must achieve in order to qualify for such an investment vehicle. We're talking about the potential investment universe from which individual securities can then be selected."

Screening can be highly focused. One organization creates a "materiality matrix" by sector or subsector – identifying the ESG issues that are most relevant. Another interviewee maintains a form of KPI score sheet, which defines specific financial and non-financial KPIs for each company.

HOW INVESTORS USE NON-FINANCIAL INFORMATION IN PORTFOLIO DECISION MAKING (ILLUSTRATIVE TABLE)

Excluding	Including
Sin stocks e.g. tobacco, defence	High performing ESG companies e.g. ESG industry leaders, best-in-class
Stranded assets e.g. oil, fisheries	Sustainability indices e.g. MSCI, DJSI, Sustainable Impact Index
High carbon industries e.g. cement, transportation	Particular sectors e.g. renewable energy
	Special focus areas e.g. SDGs, impact investing

SUPERVISORY BOARD MEMBER OF A LEADING ASSET MANAGER

"If companies behave badly when it comes to 'E' and 'S', especially when it comes to the environment, then they drop out right away or are only kept in portfolios if they make visible efforts to improve their carbon footprint."

One interviewee explains that in order to be considered for a fund, a company must achieve a certain composite rating indicative of its ESG performance. The investment organization maintains its own proprietary database containing relevant information on companies. This includes a specially calculated uniform ESG rating, created by applying algorithms to ESG data from leading information providers. It also takes account of the ex-ante view of internal analysts i.e. those analysts' views of ESG issues in relation to individual companies. The database helps analysts and portfolio managers to identify whether a company is high risk due to controversy e.g. in relation to the UN Global Compact principles or in relation to climate risk, including whether its performance is worse than its peers.

Impact investing

Although mainstream investors increasingly use non-financial information for screening purposes, impact investors have particular needs in this respect. One impact investor explains: "In traditional investing, the only measurement for success is profit maximization, which is legally dictated through fiduciary responsibility. Since the 1980s, impact investors have begun adding their values to traditional for-profit metrics. They are trying to integrate metrics for people and the planet with profit criteria, unfortunately without much success. This will change only through appropriate legislation when people and the planet are no longer considered externalities, but become an integral part of what I call Integral Investing." For impact investors, investee companies must meet stringent criteria, including requirements for a corporate culture that embraces the idea of the integration of people, planet and profit. The decision-making process for any investment is intensive, involving direct interaction with companies and extending far beyond information provided by databases or any corporate reports. [3]

However, even for impact investors, financial sustainability and profit generation is a requirement. One investor aims to invest capital in longer-term infrastructure projects to protect the climate by reducing 1% of global CO_2 emissions. Thus, all potential investments need to contribute to this goal by bringing "significant added value in terms of CO_2 reduction". The investor notes that fund managers' bonuses are dependent on achieving both financial and climate-related hurdles. An "impact measurement management system" is currently being developed, which will include ESG and SDG criteria.

For impact investors, however, current ESG reporting can seem like simply "ticking the box" rather than a "serious, deep integrated measurement". One provides her definition of sustainability, as follows: "If a company works in such a way that our grandchildren and great-grandchildren find a habitable and beautiful planet, then it is sustainable. And if they do not, it is not sustainable." In this investor's view, ESG reports, although a step in the right direction, do not do enough to ensure there will be a habitable planet for future generations. With reference to the warnings of the Intergovernmental Panel on Climate Change (IPCC) that carbon emissions need to be cut by 45% by 2030 to restrict global warming to 1.5°C she calls for more ambitious goals to measure the companies' performance against, rather than for a compliance exercise.

VALUATIONS

In addition to serving as pre-selection criteria for the investment universe, non-financial information can also influence investment decisions with regard to the valuation of particular companies. The example of a classic discounted cash flow (DCF) model shows that non-financials can go into the valuation in various ways.

BASIC DCF MODEL (SIMPLIFIED)

$$Equity_{MV} = \sum_{t=1}^{\infty} \frac{CF_t}{(1+WACC)^t} - Debt_{MV}$$

where,

$Equity_{MV}$ = market value of equity
CF_t = cash flow in period t
WACC = weighted average cost of capital
$Debt_{MV}$ = market value of debt

Cash flow estimates

Starting with the numerator, non-financial KPIs can be used to estimate future cash flows. The use of CO_2 is one example that is reflected in this approach. With the existing EU Emission Trading System and its CO_2 pricing, carbon use is often already included in financial figures. However, one interviewee gives the example of a hypothetical CO_2 price that can be considered for airlines, even if they are not connected to the European trading system. Given the possibility of a future internalization of such effects – e.g. through future regulation or taxes or through a potential decrease in revenues – there might be an effect on future cash flows.

Investors will consider whether ESG factors will require a company to invest in order to adapt and survive. One interviewee gives the example of a company affected by climate change, where capital expenditure may well be needed to change its business model: "If a company is very much affected by climate change and does not invest money, it will not be able to change its business model in the future. This is why these capital expenditures are extremely important – the extent to which ESG developments require future investment." Such assessments also affect forecast future cash flows.

´On a more general level, encouraging non-financial indicators can also enable analysts to forecast cash flows with more confidence and make judgements about the potential growth rate of cash flows. One equity analyst explains: "If one believes that companies act in a socially responsible manner towards their employees and stakeholders, then one can assume that a certain excess return can be sustained over a longer period of time. So you gain more confidence in future cash flows."

Balance sheet extensions

Instead of going into the projection of future cash flows, non-financial information can in a similar vein also be used to recognize certain additional balance sheet positions, "an ESG balance sheet extension" as one business valuation expert calls it. For example, this could take account of some form of social debt or social burden. (In the valuation model, this would be reflected in the calculation of the company's equity value – by subtracting the value of debt from the value of the entity).

A range of potential adjustments can be made to consider the sensitivities of various issues – indicating the range of impacts certain non-financial information could have. Adjusting for CO_2 emissions is relatively easy since the introduction of the EU Emissions Trading System. However, companies could do harm to the environment in other ways, through pollution, excessive use of water or damaging rainforests. As the valuation expert says: "They build up some sort of environmental liability that does not show up in a financial accounting balance sheet, but which might be a liability from an ESG point of view."

The same goes for social issues, such as poor treatment of suppliers. For example, squeezing down on supplier prices and failing to monitor quality resulted in the horsemeat scandal of 2013. Food producers and supermarkets, including Tesco, were badly affected by the loss of reputation and customer confidence in their meat products. As one interviewee says: "It was a big social liability… It would be interesting to know such things in advance. From an investor point of view, if you think there are some externalities like this which might get internalized later, either by the reaction of society or taxes or other regulations from the government – then it's worth taking it into account."

As another example, Adidas suffered when allegations were raised that some of its football production had involved child workers. Adidas customers reacted negatively and the company took measures regarding its supply chain behavior. "It's not that Adidas has morally or ethically better management; it's simply they understood it has consequences for their revenues," comments one interviewee.

In contrast, most customers of fast fashion do not appear concerned about supply chain issues such as low pay or poor conditions of workers. "But that's also a social debt," says a business valuation expert. "It might be that one day awareness in society changes and customers say they do not want to buy these clothes any more if they are not fairly produced. It could be regulated or a tax put on it. That's some sort of social debt that could occur. But it's tricky to properly take this into account."

Discount rate adjustments

Moreover, non-financial information can also impact the assessment of risks, which are reflected in the denominator in the DCF model, through an adjusted discount rate.

Investors identify a range of risks that could affect the discount rate, including risks linked to governance weaknesses, potential future regulation and strategic positioning.

As one investor identifies, one "classic risk" that would affect the discount rate is poor corporate governance. There might, for example, be concerns about a weak supervisory board. This does not necessarily mean that the company will generate worse cash flows than expected, but causes some uncertainty about its ability to cope with unexpected problems. "Anything that touches on the subject of uncertainty, or that reduces visibility so that I simply cannot make the forecast so accurately, these are topics that are more likely to be reflected in the interest rate," says a business valuation expert. The DCF model allows the uncertainty to be "mapped".

An investor's assessment of strategic risks can also be incorporated into the denominator. One interviewee gives the example of an oil company that increases its activity in deep-sea wells, Arctic wells and oil sands, with the result that its reserves portfolio and operations become riskier. This would be recognized in the DCF model by increasing the denominator, so increasing the discount factor and resulting in a smaller net present value – and ultimately a lower fair value of the company's shares.

Investors may consider such issues from a sector perspective (where there are similar drivers and non-financial performance indicators) and from an asset class approach e.g. equity or bonds.

EQUITY ANALYST

"If the non-financial indicators are pointing in the right direction, a lower interest rate can be justified than for a business where it is more difficult to assess or where you see problems and risks. I would compensate for this with a higher interest rate."

Sources of non-financial information

Investors and analysts draw on many different sources of non-financial information. What they use and how many sources they draw on is inevitably affected by their role e.g. whether a manager of a large investment portfolio containing hundreds of companies, a sell-side analyst focusing on a highly targeted sector, an ESG specialist or an early-stage investor.

DATABASES

Investors make extensive use of information streams, databases and ratings from third party information providers such as Bloomberg, Reuters, MSCI, Vigeo Eiris, imug, Sustainalytics, ISS, Trucost, Arabesque and ecoinvent (a life cycle inventory database) – to name a few.

The advantage of data from such providers is that it is generally standardized and comparable. It also needs to be objective. "I only rely on the information that someone has really measured, where there is no great subjective evaluation," says a business valuation expert. If a database identifies some aspect of a company as "subjectively good", the analyst will want to check back to original sources if there is time, which is highly dependent on the number of shares in the portfolio.

One interviewee found the introduction of ratings related to the annual general meeting (AGM) helpful for assessing administrative and legal issues across multiple countries: "I cannot judge the quality of the rating, whether it was right or bad. But it has at least given me the opportunity to compare and understand what the company is doing or what has just been criticized in the rating, so that I can discuss and debate it with the company. So agencies could have an important role to play in assessing [information] and making it useful and readable, digestible for the financial-driven investor."

Technology has made data providers' services even more useful. One equity analyst says: "Data quality has improved massively, and so has access to the data. With just one click, you can pull it into Excel or have a general overview without having to download the figures."

Ratings or scores by different agencies are not necessarily comparable, however. One interviewee, referring to the company scores generated by some specialist ratings agencies, added: "We did a study and found that these scores sometimes run in completely different directions depending on which criteria are weighted more heavily. In the extreme case there was a stock that has 80 on one score and 20 on another. This showed quite drastically that no real consensus had yet been found in the financial world."

One interviewee, working in sell-side research, "hardly ever" uses databases. He prefers to use material produced by companies directly – particularly annual reports, but also other documents and material produced "on demand".

Database information is not generally sufficient to meet all investor needs. For example, if a database indicates that an issue is still pending, investors can go directly to the company for further information on the current situation, any provisions relating to this issue and financial impacts.

In addition, bare metrics or ratings do not indicate threats to the business model or company strategy. As one interviewee explains, database metrics "help us to get a feel for where the company stands today... But depending on the issue at hand, we also need to look at the companies' annual reports or corporate responsibility reports... So we cannot completely ignore corporate reporting."

HEAD OF MUTUAL FUNDS

"It's a bit like a mosaic. We turn over [a great] many mosaic pieces to get the whole picture. And this is based on a variety of sources of information."

ESG INTEGRATION SPECIALIST AND FORMER ANALYST

"Metrics and information from data providers are only a starting point. But in order to really develop an opinion on what impact it can have on the business model, competitive position and value of companies over the next three, four, five years, we must sometimes rely on company reporting or talk directly to the companies and ask direct questions."

COMPANY REPORTS

Investors refer to a wide range of company reporting, including annual reports, integrated reports and sustainability reports. Those using company reports in preference to databases are typically individuals working in a consultancy role or focused on small numbers of investments, rather than managers of large portfolios. "My preferred source is clearly what the company produces itself. I look less at databases," says one equity analyst. As well as current and past annual reports, other material such as company statutes (e.g. to determine the rights of minority shareholders) and remuneration reports can give useful insights. For example, a remuneration report gives insight into the incentive structures in place and what KPIs influence management remuneration.

Company reports can also help to show what targets a company has set itself, whether these targets make sense and ultimately whether they have been achieved.

One equity analyst says: "My aim is to get as good an understanding of the company as possible… and to read widely, read the annual reports from start to finish, maybe even read the footnotes to understand accounting." Such detailed reading might give the investor some competitive advantage when making investment decisions.

According to one equity analyst annual reports now give more attention to non-financial information, including ESG topics. He says: "It is quite clear that the non-financial focus has massively improved and that the focus is now very prominently on what happens outside the financial figures – which is desirable… These are important factors that deserve to be presented more prominently in a report, and they really do add value for shareholders or the addressees of financial reporting in general."

One sell-side research analyst considers companies' sustainability reports to be less relevant than their annual reports: "Everything that is really relevant is also included in the annual report – and also in the form that the analyst needs it in the end." Standardized tables simply stating emissions or electricity usage are "not very interesting".

Investors and analysts are also interested in what companies do not disclose in their various reports. The omission of disclosures raises a red flag, particularly if a company stops providing previously reported KPIs. As a business valuation expert says: "Corporate disclosures are central sources of information in every respect – whether it is in the integrated report or the sustainability report or the normal annual report, or whether it is on the website. Especially for larger companies, one always knows what it means if disclosure is missing."

DIRECT DIALOGUE

Investors will go directly to companies to check their understanding of reported information or gain updates on ongoing issues. This is particularly likely when there is a lack of standardization around reported information.

One equity investor would seek information directly from a company "to make sure that what is written there [in a report] is what we understand it to be and not otherwise. This standardization is missing at the moment. And the (partial) lack of quantification is a problem where one would simply like to have more information, especially on risk aspects."

OTHER SOURCES

Investors and analysts will use any sources of information that help them form a view on a company, including reports from directly comparable competitors. They also draw on industry and sector reports, including reports from trade associations and sell-side research.

One mainstream mutual funds investor says: "I can get… market or transaction data from one sector and try to break it down to a single company. For example, I can look at aircraft movements and see what this data tells me about Airbus. We use a lot of such data for investment decisions."

However, industry reports can sometimes be "rather journalistic texts that provide background information. They are not very quantitative or analytical", says one sell-side research analyst.

Targeted internet searches are also undertaken to look for statistical material on a topic of interest. One mainstream investor says: "There are techniques where we look at the pricing of individual products via web scraping and ask: is the pricing adequate for the expected margins, or better or worse?"

In addition, websites such as Glassdoor and kununu can give insights into corporate culture, which investors can find hard to do from the outside.

How integrated reporting could help to improve non-financial disclosures

The non-financial information that companies provide often suffers from certain weaknesses, compared with what the investors are looking for. Integrated reporting can help to address these weaknesses, through the content included and the principles that reporting entities apply.

RELEVANCE AND MATERIALITY

As the disclosures required of companies increase, annual reports can become increasingly lengthy. Investors want companies to focus on material issues to help them form the big picture in terms of its performance and potential. This can be obscured by inclusion of matters that are not material and provided in excessive detail. As a sell-side research analyst says: "Sometimes companies overload the annual report with details: a lot of trees, but little forest. This is often seen instead of clearly explaining the strategy... or what is the business model. Large companies in particular get carried away with details, but sometimes forget to present the whole picture."

One interviewee says that less can be more if information is relevant and presented in an integrated way. Companies should focus on the ESG issues that are most important for them, in their sector and in the countries where they operate. This is far more useful to investors than reporting on a wide range of issues that have no great importance to the company.

For example, water consumption may be highly relevant in some sectors, such as oil and gas, but not for internet-based businesses, where electricity use would be of greater interest. The relevance of disclosures is therefore on a case-by-case basis.

How integrated reporting helps

Integrated reporting involves clear explanations of a company's business model. Investors value information on the business model, as one sell-side research analyst explains. Some companies only make limited statements about what they make or sell. "That's where the good and the bad annual reports differ. There are companies that really do try to explain to the layman what they do. And that is important, especially when it is not necessarily obvious or in need of explanation."

Companies applying the <IR> Framework also provide information on the various capitals that their businesses use, transform and create through their activities. One interviewee finds it hard to imagine life without a multi-capital approach to company analysis. The stakeholder-based approach to integrated reporting supports the provision of useful information to investors – but the content of integrated reports needs to be relevant and sufficiently precise.

Human capital is increasingly important in a today's world, as one equity analyst points out: "The business world is changing massively into a service industry. We are producing less with classic machines and more with intellectual know-how... That makes the employee much more relevant." The "creative output" and ideas of employees are increasingly important for companies' success. Assessing human capital is therefore immensely important: "That's what ultimately determines financial success."

One interviewee thinks it is good to "sensitize" people to the concepts of different capitals, including natural capital, because these do have an impact on financial value. Society is increasingly punishing companies that damage the rainforests, for example, through consumers no longer buying their products. "That's where the companies feel it," he says. "That's where the link between the natural capital or natural value and the financial value is."

CONSISTENCY OVER TIME

Information that is comparable and presented over time is also valued. "I would definitely look at everything that is standardized and comparable and is presented over time," says one equity investor. A basic data point on tons of CO_2 generated, for example, is not necessarily useful in itself.

How integrated reporting helps

When companies apply the <IR> Framework over successive years, they provide a track record of performance that users of their integrated reports value. Investors appreciate the fact that companies such as BASF and SAP have been applying integrated reporting principles for some time, with the result that detailed information over successive years is available. One senior analyst comments: "You can see what objectives the companies have set themselves. How has that worked on the timescale? Did they follow up on it, or were there reasons why they deviated linearly from it? This is very, very informative."

RELIABILITY AND COMPARABILITY

Investors want non-financial information to be reliable. However, some information tends to be subjective. One interviewee refers to the difficulty in assessing management quality: "It's difficult to compare or standardize everything; that's a very subjective perception."

This is why investors also want to rely on auditors in checking the non-financial information and giving at least some form of assurance. One interviewee thinks that a regulatory requirement for reasonable assurance on non-financial information would be helpful, including a qualitative assessment of the reporting systems underpinning the production of non-financial information.

Where possible, metrics are desired. Qualitative explanations are valued too, but may need to be treated with care. With a description "you always run the risk that the company presents itself too beautifully and this often raises a suspicion that it has been portrayed in a too positive light", says one investor. For example, climate risks may be discussed, but rarely in a quantitative way. Metrics help to make the information provided more verifiable and at the same time more comparable across companies.

Presenting non-financial information in a comparable way is key for investors. They want to be able to compare companies within their sectors or peer groups, rather than just looking at basic performance data. As one analyst notes, RWE will never perform as well as SAP in terms of CO_2 emissions. "But they can be very transparent within their peer group – the utilities."

However, non-financial information as currently reported is not always comparable between companies. "Comparability is not always guaranteed, especially since we are now talking about sustainability issues, where not only quantitative but also qualitative elements play a role," says one mainstream investor. For example, the results of employee surveys and customer surveys may not be readily comparable. "Many people have good approaches. There is also no right or wrong. But sometimes it is simply difficult to compare the data."

One interviewee refers to polymer materials producer Covestro, which co-founded the Carbon Productivity Consortium, an initiative to track the use of carbon employed as a resource throughout the life cycle of a product with the goal to increase the return on carbon employed (ROCE). He sees this as "interesting, but it is not really comparable".

Because the information that companies report is not standardized, "automated evaluation" of ESG performance is not possible. Investors cannot automatically compare the accident frequency rates of two companies, for example.

Different ESG frameworks also have different approaches, which may allow for some different interpretations. For example, under the GHG Protocol, companies may have different approaches to calculating their Scope 3 indirect emissions. "There is a lot of data available, but they all still have corridors of interpretation," says one impact investor.

The Global Impact Investing Network (GIIN) provides another example. One investor queries the meaning of "fair working conditions". This lack of clarity, as well as the complexity associated with the many sustainability standards and frameworks, can be challenging for mainstream investors.

How integrated reporting helps

The <IR> Framework identifies content elements that companies should include in their integrated reports, including the business model, resource outlook and performance. With reporting on the business model, for example, details will be specific to the company. Comparability will be a subjective issue in the sense that investors and analysts can compare how clearly companies explain their model, and other factors such as the risks and opportunities they face.

Over time, greater standardization in reporting may develop, particularly given the cooperation between organizations involved in corporate reporting and sustainability standards, such as the IIRC and the Sustainability Accounting Standards Board (SASB), which announced their intention in November 2020 to merge into a unified organization, the Value Reporting Foundation.

Some investors would appreciate the development of accounting standards that address sustainability. As one says: "The IASB [International Accounting Standards Board] must define a set of rules on sustainability in the long term so that the topic can be included in normal accounting – then via IFRS accounting."

However, investors do welcome experimentation and initiatives such as the Value Balancing Alliance (VBA), whose goals include standardizing how to assess and monetize the value of a company and its financial and pre-financial value contributions to society. The VBA seeks to design a disclosure framework enabling stakeholders to compare natural, social, human and financial capital performance across companies.

CONNECTIVITY

Simply adding non-financial information to financial statements is an inadequate response to investor needs. Interviewees call for connectivity so that they can see the company has a clear strategy. Non-financial information needs to be integrated into financial reporting in a way that is "transparent and consistent", a senior analyst observes. Although both financial and non-financial information is provided, they are "not yet put in relation to each other", one impact investor says.

Similarly, an ESG integration specialist and former analyst asks: "How am I supposed to integrate this myself when I notice that the company is not integrating it at all? I can make up my mind based on the data I get. But I do not know. The company itself does not know… so how can I do that sensibly?"

To explain the value of connectivity, one interviewee takes the example of an IT company, for whom the workforce has a material impact on performance. If the company invests in healthcare for its employees, it could achieve a lower rate of sick leave and absenteeism. There is therefore connectivity between healthcare expenditure and performance.

How integrated reporting helps

Investors and analysts familiar with integrated reports believe they are most useful where there is a "comprehensive attempt to link the non-financial to the financial in the reporting", as one interviewee says.

Integrated reports can combine comparable metrics with written explanations of issues such as corporate strategy. Investors welcome integration of non-financial information with the strategy and business model. One interviewee says: "If you drill a bit deeper, the exciting thing is to see which indicators the company identifies that have materiality on the cost or revenue side." For example, whether CO_2 emissions have an impact on the P&L.

Assessing a company's competitive position is one thing. Converting that assessment into financial numbers is "an extremely difficult step". Integrated reporting is particularly good "if you can get this connection", says a business valuation expert.

Linking actions with the financial results is important to investors. It remains a challenge for the companies, though. As one interviewee notes, when a company reports that it uses renewable energy, has covered its roofs with photovoltaic modules or employs many trainees, this may be good marketing and also good for stakeholders such as the local community. However, these actions include additional costs. This is why one equity investor believes that companies avoid making a "financial connection".

AUTHENTICITY

One senior analyst wants to see "authenticity in the transmission" of non-financial information. Investors want to know what pieces of non-financial information management themselves think important.

Another interviewee believes that some companies in the utilities sector have made progress in explaining their way of thinking in their management presentations. For example, they explain why some ESG issues matter, what goals they have set and why. This helps investors to understand why the company is taking certain actions and the impact on the business model and competitive position.

Lack of authenticity in transmission may be linked to the fact that companies are not thought to be thinking and acting in an integrated way. One ESG specialist and former analyst says: "Many companies disclose something about sustainability, but that is not an important part of the company's strategy. In these cases, what is missing is 'integrated thinking'."

"The challenge is less in the data; the challenge is that the sustainability department and the accounting department have to work together, which is like fire and water," one interviewee says. CFOs may see integrated reporting and increased ESG reporting as costing money, when their aim is to control expenditure. Sustainability teams may lack power and authority to drive change, sometimes having no board representation.

How integrated reporting helps

Companies can expect to benefit if they present their story clearly, in an authentic way through integrated reporting. "It helps companies because they can steer analysts and investors in the direction they want them to go," one interviewee suggests.

Integrated reporting encourages integrated thinking, which in turn underpins better integrated reporting through a virtuous cycle of continuous improvement. This supports the authentic development and identification of companies' strategies and business models. The IIRC is publishing a series of case studies exploring the relationship between integrated thinking and strategy across a range of businesses and institutions, which are available on the IIRC's website.

Investors and analysts would like to see more integrated thinking taking place within companies, as this would mean that relevant ESG issues would be reflected in the company strategy and the impact of such issues would be linked to financial performance. For one interviewee, integrated thinking is "the link between sustainability performance and the financial impact of the company".

A senior analyst expects in future there to be more scrutiny by capital markets of whether resources are being allocated in a way that aligns with the company's strategy, rather than just scrutiny of, for example, profits and cash flows. This is because some vital resources will become increasingly scarce. There will be heightened interest in whether companies are able to achieve financial goals with fewer resources. The capital markets may then value such companies more highly.

IMPACT INVESTOR

"If sustainability is a satellite function and is not considered in an integrated way, then it does not have a really relevant effect on the company."

Levers for encouraging the integrated reporting of non-financial information

Gathering and reporting non-financial information requires resources and incurs costs. Companies will only undertake it if they see benefits from doing so or are required to do so by some mechanism, be it regulatory or due to market forces.

INVESTOR PRESSURE

Pressure for change lies to some extent with the investment community. Investors exert pressure on companies individually when asking for specific non-financial information or by excluding them from investments if they fail to meet certain criteria or performance hurdles.

One mainstream mutual funds investor says: "There are KPIs where we have made it our business to get them reported as they are now. And that is also in the long-term interest of the company… We have an influence there and we use it very actively." This lever is typically pulled through written correspondence, conversations and "constructive dialogue".

Investor involvement in various ESG initiatives (such as CDP, the Climate Disclosure Standards Board (CDSB), the Task Force for Climate-related Financial Disclosure (TCFD), the Global Reporting Initiative (GRI) and the Principles for Responsible Investment (PRI)) also has an impact in terms of inducing companies to provide relevant non-financial information. As a senior analyst says: "It's not so much a wish list anymore, it's just what global investors are asking for… The momentum is big enough to put pressure on companies…"

Many investors are becoming more demanding in terms of the timing and format of the reporting of non-financial information. One interviewee from a leading asset manager says: "Everyone who does not do it at all is increasingly no longer being considered by us. Even those who do the non-financial report separately, but also three months later are also on the wrong track."

Some investors will use their voting power in annual general meetings to try to drive improved reporting. One interviewee says: "It could be that we do not grant discharge to a board of directors or supervisory board due to a lack of disclosure or because of qualitatively incorrect, poor information." Such voting activity will often relate to strategy issues, such as whether sustainability goals have been achieved or whether non-financial performance indicators form part of the remuneration system.

BUSINESS VALUATION EXPERT

"You can hardly expect companies to change their reporting if they do not get the pressure from outside."

ESG INTEGRATION SPECIALIST AND FORMER ANALYST

"Not only do we demand that they [companies] make ESG information transparent, but we also say that it would be most helpful for investors if they did integrated reporting in accordance with the IIRC. This is always a topic of discussion in our management meetings."

MARKET FORCES

One interviewee believes that demand for sustainable investments and products that perform well on an ESG basis is now exceeding supply. Therefore, there is increasing justification for investors requesting that companies produce ESG information, potentially in integrated reports, which compile non-financial information in a "meaningful way".

IMPACT INVESTOR

"I believe that realizing that the market is changing... and that there is an economic necessity has a different effect than when the legislator says: 'You have to do it now.'"

Research suggests demand for ESG investments will grow further. A survey of over 4,600 consumers in 14 countries by Vontobel in 2019 found that 59% of respondents did not know an ESG approach to saving and investment was even possible; 47% would welcome greater support and advice on ESG from their advisers; and 49% would like their advisers to provide more information on ESG topics. In addition, 65% believed ethical businesses would deliver better investment returns. [4]

Some interviewees suspect investors have not pushed hard enough in Germany for integrated reports and non-financial information. As a result, even German companies that initially embraced integrated reporting may have lost some momentum. However, as investors face new regulations increasing their need for ESG, sustainability and non-financial information, their demands of companies are expected to increase.

REGULATION

German companies must meet certain reporting requirements by law (see Appendix 2 for a brief overview). One relatively recent development is the requirement for certain large public interest companies to supplement their management report with a non-financial statement for fiscal years from 2017 onwards. This requirement was introduced by the Corporate Social Responsibility Directive Implementation Act (CSR-RUG).

Investors generally feel the CSR-RUG has had a positive impact on reporting, firstly by increasing the quantity of information available. One equity analyst says: "The obligation to do more on the part of the company has already massively improved the information base."

One interviewee welcomes the fact that the CSR-RUG has resulted in "greater openness", but sees there is still "dark and light" – a wide range of reporting.

Overall, however, the quality of reported information is thought to have improved. At the same time, the perception of the importance of this information internally – up to the supervisory board – has increased. One interviewee says: "The audit committee usually has the non-financial statement backed up with limited assurance." This helps to ensure that reported information is robust and reliable. However, one investor even calls for a higher level of assurance: "We demand reasonable assurance. And we want to have an integration into the ICS [internal control system] and thus also into the compensation programmes."

As a result of the CSR-RUG, investors feel they can now more easily compare information. When companies within a sector all report information such as CO_2 emissions, poor performers then come under pressure to explain why and ultimately to improve. The potential for improvement becomes more transparent.

However, one interviewee feels that regulation such as the CSR-RUG could result in bloated company reports. Non-financial and ESG issues could "dilute the report, but are not really enlightening" unless they are relevant to the company.

The CSR-RUG had little impact on smaller companies. Their responses to such regulation tends to depend on the attitude of management and their desire (or otherwise) to present themselves like a DAX company. Voluntary adopters that want to stand out will embrace changing requirements, even when not legally binding. Others will not. One equity investor says: "Unfortunately companies see it to a large extent more as a burden than as a possibility to position themselves better or differently. My impression is that many are not yet ready."

Need for more regulation?

Some investors think that further regulation is needed to stimulate enhanced non-financial reporting by companies and even integrated reporting. A senior individual at a leading asset manager says: "You won't get it [more integrated reporting] through a pure market mechanism." Barriers such as lack of resources and increased costs could limit progress. One interviewee fears that, without regulatory pressure, many companies would lack the "courage or desire" to improve their reporting.

However, regulations are likely simply to require increased disclosures, which in itself will not lead to more integrated reporting. One interviewee is concerned that companies may focus on providing the disclosures, without giving more thought to how specific issues interact and affect the business model, corporate strategy and performance.

One interviewee working in sell-side research is also skeptical about the value of a report or integrated reporting that is regulatory driven. In this case, companies may view the regulated reporting as just extra work, potentially resulting in disclosures that investors see little value in reading. He says: "If it [reporting] is not demand-driven, but imposed from above, then it is often no longer interesting or relevant."

Investor regulation

As well as companies, investors are also facing new regulations that affect their demand for and use of non-financial information. One interviewee refers to BaFin, the German Federal Financial Supervisory Authority, which issued guidance in December 2019 on how supervised entities should deal with sustainability risks. [5] This requires that entities include sustainability criteria in their risk control systems. Aggregating this data will create "statistical noise". As the investor says: "This is the spearhead, where this non-financial information will have an impact beyond portfolio management and beyond the research process."

In addition, from March 2021, retail investors' sustainability preferences must be checked by organizations such as asset managers and banks in Germany. A classification system will be introduced, based on certain criteria set by BaFin. Specific company information will be needed in order to ensure customers' sustainability preferences are met in the investments made on their behalf. "Companies that do not provide this information are not then eligible for investment," one interviewee notes.

However, one impact investor fears that additional regulation could reverse progress already made in ESG investment activity. For example, if the EU requires funds that call themselves "green" or "sustainable" to meet certain criteria, some financial services providers may not issue such products unless there is market demand for them to do so. They will not want the regulatory burden. Some existing fund managers could even withdraw from the arena.

Global standards

German investors recognize the global nature of capital markets. Ideally, therefore, standards for the reporting of non-financial information in an integrated way should be global.

One senior analyst believes national identity will become less important in terms of reporting – regardless of whether the global standard embraces integrated reporting or any other approach. "You have to look at things more globally or at least regionally and get away from this territorial or national view. That simply doesn't help, because the investor and the capital market are not local."

Another investor would like to see a "preferably global" approach to the reporting of non-financial information. "But to get ahead at all you start with the EU. And here in Germany too."

One investor believes the EU Action Plan puts Europe ahead of other parts of the world and expects the rest of the world to have to follow suit: "Because the investor is globally oriented, the better standard always prevails."

However, there is some concern that standardization can reduce some of the richness in reporting. Companies may stop reporting some information they previously had identified as relevant to their own situation. "Standards always develop, and with standardization, information is lost again," says one mainstream investor.

ESG INTEGRATION SPECIALIST AND FORMER ANALYST

"Regulation – even if it does not create a perfect world – at least helps to move in the right direction."

Summary and outlook

It is clear that investors and analysts rely on non-financial information when making investment decisions and forming an opinion on a company's value. Traditional financial reporting alone is no longer sufficient for many investors.

The range of non-financial information that investors and analysts use is extensive, including both metrics and qualitative descriptions. Third-party data providers deliver important services to investors, helping them to access data quickly and in a relatively comparable way. However, many investors and analysts still turn to company reports to gain more insight into the many and varied drivers of a company's performance and value. In doing so, they want to see what particular ESG aspects management teams and supervisory boards consider important. They aim to build a more complete picture of the business, its risks and opportunities.

Investors and analysts appreciate the strengths of integrated reporting. These include the focus on the business model, coverage of a broader range of capitals and the importance placed on connectivity across all areas of reporting and between financial and non-financial elements. An integrated report supports the needs of investors by helping to identify companies which are governed, structured and managed to support long-term value creation.

Investors do not necessarily agree, however, on the best way to encourage increased reporting of non-financial information in an integrated way – whether this can be achieved by investor pressure and market forces, or whether further regulation is required.

Looking ahead, on the international stage, progress is being made towards a reformed corporate reporting system that gives equal weight, where appropriate, to financial and non-financial information. This is evidenced by the cooperation of five global organizations involved in corporate reporting and sustainability standards: the IIRC, CDP, the Climate Disclosure Standards Board, GRI and SASB. It is hoped that by sharing and collaborating, these organizations will establish a global consistency in reporting that will reduce burdens on reporting entities while facilitating analysis, interpretation and action by users of information.

Consideration is also being given to the creation of a new sustainability accounting standards board that would exist alongside the International Accounting Standards Board. This could help in the creation of a reporting system that delivers consistent, comparable, reliable and assurable information relevant to enterprise value creation, sustainable development and evolving stakeholder expectations.

Our research among German investors and analysts shows that companies have improved their provision of relevant non-financial information. The investment community does now have access to a wide range of information on ESG topics that supports their activities. However, the quantity and quality of disclosures could be improved, particularly when considering the needs of specialist ESG and impact investors.

Investors want to see greater integration between the financial and non-financial information that companies report. Integrated reporting, if embraced by more companies – not only in Germany but across Europe and the world – could make a significant contribution towards closing the current information gap and meeting the needs of a wide range of investors.

EQUITY ANALYST

"In the end, integrated reporting has to become the actual reporting."

APPENDIX 1

Interview questions

Our interviews with investors and analysts were structured on the basis of the following questions, although we encouraged free-flowing discussions reflective of participants' interests and experience.

1) To what extent do you currently use non-financial information to inform investment decisions? Would you routinely review an investment portfolio against ESG (Environmental, Social and Governance) criteria? Do you do so only some of the time or never?

2) What non-financial information do you consider useful when making investment decisions?

- Can you give some examples of the kinds of non-financial information you consider useful and how far this information has supported your decision-making?
- How would you characterize your use of non-financial information: as a constraint/ secondary condition to the financials, as a potential opportunity or risk, as a contribution to the firm's long-term value creation, as an indicator of future cash-flows etc.?

3) What types of corporate reporting would you use to access relevant non-financial information for investment decisions? E.g. corporate annual report, sustainability report, GRI indicators, SASB indicators, separate indices such as MSCI, DJSI etc.

4) To what extent has the increase in non-financial disclosure in recent years helped improve your decision making?

- Do you find this information easy to find?
- Is it presented in a way that is easily comparable between companies?
- Do you consider it to be robust?
- Is it relevant and decision-useful for you?
- Is there clear linkage with financial information?

5) Has the introduction of mandatory non-financial reporting for the largest companies helped improve corporate reporting in Germany?

- Has the quality of non-financial information improved since the introduction of the CSR Directive Implementation Act?
- Is the information presented more consistently by mandated companies?
- Of the main reporting methods under the Act (Management Report, Sustainability Report, Integrated Report) is there an approach you favor? If so why?

6) Turning now to integrated reporting, how familiar are you with the <IR> framework?

- What in particular makes you consider integrated reports useful for investment decisions (compared with traditional corporate reports): e.g., the business model, description of an organization's strategy, the wider definition of a firm's value through the concept of the six capitals, the process of value creation, the way that information is presented (connectivity, conciseness etc.), particular content?
- Are you aware of which German firms currently produce an integrated report?
- What are your experiences of firms that do so – especially regarding how they support your decision-making? Is an integrated report more useful or less useful than a traditional corporate report for investment decisions? If so, why?

7) What are your views on the future of integrated reporting in Germany?

- Do you expect more German firms to publish integrated reports in the future (and would you welcome that)?
- What would be the three most effective levers to increase adoption of integrated reporting in Germany?
- What should the IIRC be focusing on to encourage market adoption of integrated reporting in Germany?

8) Are there any other observations you would like to share with us?

APPENDIX 2

A brief overview of corporate reporting requirements in Germany

In Germany, medium-sized and large corporations are required to prepare a management report (Lagebericht) providing an appropriate view of the course of business and the position of the company. The management report and financial statements typically form the basis of a company's annual report.

The management report must satisfy certain principles of proper management reporting, including completeness, reliability and freedom from bias, clarity and transparency. It must also contain certain content elements, including the most important financial and (for large entities also) non-financial performance indicators, and an explanation of the company's expected development and significant risks and opportunities.

The German law – the Commercial Code (Handelsgesetzbuch (HGB)) contains the specific requirements. According to Article 289 (1) the management report has to include an analysis of the entity's economic performance, which must include KPIs together with their relation to the amounts and disclosures in the financial statements. According to Article 289 (3), for larger entities (according to size criteria also defined in HGB) this also applies for non-financial KPIs, such as information on environmental or employment matters when they are relevant to an understanding of the entity's business performance.

These requirements are specified in the German Accounting Standard governing the group management report (GAS 20). The most important financial KPIs are required disclosures in connection with the reporting entity's report on its economic position in the group management report. Since GAS 20 came into force in 2013, non-financial KPIs would supplement these if they are material for an understanding of the course of business and position of the group. Thus, their inclusion is subject to the entity's discretion, as applied in the individual circumstances (GAS 20.54). In either case these should be KPIs used for internal management purposes for managing the group. GAS 20.101 et seq. and GAS 20.284 give further details and provide examples.

GAS 20.26 requires consistency in the content and format of the management report. As the KPIs reported are specific to the individual company, there is no standardized calculation method in place, so consistency in methodology is important. According to GAS 20.113, significant changes (in the outcome – i.e., not in calculation methodology) from the prior year must also be presented and discussed.

These KPIs are subject to assurance, since the auditor in Germany is required to express a reasonable assurance opinion specifically on the management report as a whole. The German Assurance Standard (IDW AsS 350) on the management report specifically mentions KPIs and stipulates the auditor's procedures.

In a separate section, for some companies, the management report also needs to include the Corporate Governance Statement, which may alternatively be published on the company's website. The statement includes a number of corporate governance disclosures like the declaration of compliance (on a comply-or-explain basis) with the German Corporate Governance Code, information on corporate governance practices and the diversity concept. In connection with this statement, the German Corporate Governance Code requires companies to publish a separate Corporate Governance Report. However, following a revision to the Code, this additional report will no longer be required.

With the exception of the aforementioned requirement to report the most important non-financial KPIs, there were no legal requirements for sustainability reporting in Germany until the implementation of the European Corporate Social Responsibility (CSR) Directive. However, since the implementation of the CSR Directive Implementation Act (CSR-RUG), certain public interest entities with over 500 employees on average throughout the year have had to supplement their management report with a non-financial statement for fiscal years from 2017 onwards. They must describe their business model and address specified non-financial aspects: environmental issues, employee and social matters, respect for human rights and the prevention of bribery and corruption. Where neccessary for a proper understanding, additional disclosures are required.

The non-financial information can be integrated throughout the management report, presented as a separate section or, alternatively, presented in a non-financial report. A fourth option would be to publish the non-financial information on the entity's website later (up to 4 months after the end of the reporting period). Companies are able to apply integrated reporting and to use frameworks such as those of the GRI and IIRC.

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The International Integrated Reporting Council (IIRC) is a global coalition of regulators, investors, companies, standard setters, the accounting profession and NGOs. The coalition is promoting communication about value creation as the next step in the evolution of corporate reporting. The International <IR> Framework has been developed to meet this need. For more information about the IIRC, or to download the International <IR> Framework, please visit https://integratedreporting.org/

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