INTEGRATED THINKING IN ACTION

Compared to non-adopters, Integrated Reporting (IR) adopters are more likely to embrace Integrated Thinking (IT) by linking CEO compensation to non-financial targets and to the ability to create long term value. They also achieve superior combined financial and non-financial performance and better ESG (environmental, social and governance) results.

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Integrated Reporting (IR) is considered an innovation in corporate reporting, as it involves a single document combining information on a firm's financial and non-financial performance. According to the International Integrated Reporting Council (IIRC), an IR reveals the ability of a company to be sustainable and create value in the short, medium, and long term by means of its different resources (i.e., the so-called six capitals: financial, human, intellectual, social, manufactured, and natural). In so doing, it also underlines the importance of Integrated Thinking (IT), which involves the consideration by managers of a more long-term and broader concept of value creation and of the capitals used and affected by the value creation process, which includes both the financial capital and the non-financial ones. IT should lead managers to integrated decision making and actions through an active understanding of the relationships between various operating and functional units that would help breaking down internal silos and promoting a shared understanding of how value is created over the short, medium, and long term. If IT is not embedded in a company's business practices, there is a risk that the IR will be a mere symbolic practice or "just another report" added to the documents already published (CSR reports, governance reports, etc.). On the contrary, when IT is applied, the IR becomes a critical milestone in the continuous journey of improvement in decision making, accountability, and communication thus contributing to support a firm's long-term success.

Appropriate compensation schemes are essential

One of the biggest challenges of IT and IR is to balance financial and non-financial goals (e.g., social, human, environmental) to ensure long-term sustainability. The use of appropriate compensation structures that include both financial and non-financial targets is fundamental for accomplishing this. Compensation schemes influence the behavior of the CEO and the management team, and will, in turn, be reflected in the decisions made for the whole company. The types of objectives included in compensation contracts suggest attention (or a lack thereof) to important elements characterizing IT, such as distinct capitals and value creation process, not only in the short term but also in the long run.

In a recent research sponsored by the Chartered Institute of Management Accountants (CIMA) (see the executive research report "Practicing integrated thinking and reporting: evidence from executives' incentives and remuneration"), we show that IR adopters incorporate a significant number of non-financial, sustainability-related targets in their design of CEO compensation packages. We focus on CEOs incentives, as they are the most influential decision makers in a company and, therefore, ultimately responsible for a firm's performance; thus, their objectives more directly reflect a firm's goals.

Compared to non-adopters, IR adopters put more emphasis on non-financial targets in defining both short- and long-term objectives for their CEOs. In fact, 92% of IR adopters link CEO compensation to non-financial ESG targets and have at least one ESG target in the CEO's short-term compensation package. 39% have both short- and long-term ESG targets in CEO compensation. The most common non-financial targets for the CEOs of IR adopters are human capital-type targets (87%), followed by social capital-type targets (31%), intellectual capital-type targets (26%), and natural capital-type targets (18%).

Integrated performance

Interestingly, our results also indicate that compared to non-adopters, IR adopters have better combined financial and non-financial performance, referred to as integrated performance (IP). IR adopters also display better non-financial performance, both in general and with specific reference to each of its three dimensions: environmental performance, social performance and governance performance.

Overall, this evidence suggests that the design of compensation can be a powerful tool to integrate sustainability dimensions into a company's decision-making processes and ensure that all the factors that are relevant to value creation are integrated into day-to-day decisions. When IR and IT go hand in hand they are really able to promote a more multifaceted and longer-term view of value creation processes within companies that ultimately translates into better financial and non-financial performance.

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