(1) Name, Position, Contact Details for each applicant

Name: Ava Wu, AFAANZ Member Number: A2399767

Lecturer, The University of Sydney, ava.wu@sydney.edu.au

Name: Shan Zhou, AFAANZ Member Number: A5135729

Lecturer, The University of Sydney, shan.zhou@sydney.edu.au

(2) Project Title

The unintended consequence of practicing integrated reporting: Evidence on opportunistic earnings management

(3) Updated Project Summary (500 words) including any variations between the project undertaken and the original application

There is no variation between the project undertaken and the original application.

<u>Project Summary:</u>

The trend for <IR> is gaining momentum worldwide. Investors are demanding extra-financial information not captured on the balance sheet such as human capital, natural capital, corporate brands and reputation, to allow them to make long-term assessment of firms' performance. But supplying extra-financial information without putting them in the context of firms' strategy and business model and linking to financial materiality has been criticized for being irrelevant and even causing information overload (Eccles and Krzus 2010). In response, companies are voluntarily producing reports in line with the principles of <IR>; Organizations such as Global Reporting Initiatives (GRI) and International Integrated Reporting Council (IIRC) are making guidelines/frameworks to help companies adopt <IR> and to promote the wider acceptance of <IR>. Regulators are also working on issuing guidelines on narrative disclosures and management commentary considering the developments on <IR> (IAASB 2017; SEC 2018).

A large body of literature documents that firms' commitment to social good helps build a positive image of caring for the society and refraining from corporate greed (e.g. Fombrun 1996; McWilliams et al., 2006; Gao et al. 2014). As such, it imposes additional costs on managers engaging in activities, e.g. earnings management, that conflict with the appearance of doing social good. In the meantime, anecdotal and empirical evidence has found that the practice of <IR> helps firms attract more long-term investors, which has the potential to discourage the short-sighted investment behaviour and earnings management (Serafeim 2015).

On the other hand, the practice of <IR> is largely voluntary and the degree to which firms practice <IR> varies significantly across firms, industries, countries and over the years (Barth et al. 2017). The <IR> framework is principle based without prescribing specific measurable metrics. The lack of financial measurability, comparability and consistency is among the major criticisms and appears to be the major barriers of the wider acceptance of <IR> by its' targeted primary audience, i.e. investors (Rowbottom and Locke 2016; Slack and Tsalavoutas 2018). As a result, it is implicated that <IR> may become a reporting fad, not embedded into mainstream investment thinking (Slack and Tsalavoutas 2018). Along this line of arguments, the practice of <IR> is unlikely to bring any fundamental changes to the firms' core operation therefore affecting earnings management activities.

Hence, it is ultimately an empirical question whether firms' commitment to <IR>, as reflected in the production of higher quality <IR> reports, is associated with the level of earnings management activities. The question is important because while we see an increasing amount of literature on <IR>, we know little about whether and how <IR> changes firm behaviour/operations, i.e. the real effects. Nonetheless, using the process of <IR> to catalyse changes in internal operations to achieve "integrated thinking" has been one of the major claims of the benefits of <IR>. Earnings management is a typical behaviour induced by short-termism, which is precisely one of the limitations that <IR> is trying to overcome. Our study therefore provides empirical evidence on the effectiveness of <IR> in curbing earnings management behaviour.

(4) Funds Granted

$5000

(5) Detailed Report on Expenditure of Funds against Budget Items, with variations explained

Funds were spent on research assistant to hand collect data, clean and merge data.

Detailed Items	Priority	Amount
Research assistant: $56.04 per hour (including on cost) @ 84 hours = $4,717	Essential	$4,717

(6) Outcomes, for example, working papers, presentations and publications (give full details, including abstracts)

This project is completed and has been converted into a working paper entitled "The unintended consequence of practicing integrated reporting: Evidence on opportunistic earnings management". The paper will be circulated to other academics to collect comments. We intend to submit this paper to the 2019 AFAANZ conference. An abstract of the paper is as follows:

Earnings management is a typical response to short-termism capital market functions. The recent development in corporate reporting, i.e. Integrated Reporting (<IR>) aims to promote long-termism in capital market decision making. We therefore provide empirical evidence on whether firms producing higher quality corporate reports in the spirit of <IR>, exhibit lower levels of earnings management. On the one hand, the practice of <IR> improves the transparency of the reporting process on both financial and non-financial information, which could limit the opportunity for earnings manipulation. Further, the practice of <IR> enhances firm reputation and may induce longer-term orientation of firms which reduces the incentive to manipulate earnings. On the other hand, the extent to which a company practices <IR> is a matter of degree and hence, subjective judgement and the practice of <IR> can be symbolic, even opportunistic than substantive. Hence, the practice of <IR> may not have significant association with firms' underlying earnings characteristics. Using multiple <IR> measures and an international sample, we discover that while companies producing higher quality <IR> reports engage in less earnings management using discretionary accruals, they resort to higher levels of real earnings management which result in an overall higher level of earnings management. Further analyses reveal that the opportunistic earnings management behaviour is most pronounced in countries where <IR> is voluntary and in countries with less developed capital markets, suggesting <IR> practice in these countries tend to be more symbolic than substantive.

(7) Future Intentions for this Project (give full details)

a. *Conference submissions:*

We intend to submit this paper to 2019 AFAANZ

b. Journal submissions

We intend to submit this paper to European Accounting Review (A on ABDC) in 2019*

(8) Summary of Outcomes and Benefits

We thank AFAANZ for the funds. This funding is particular useful in helping the early-career researchers, Ava Wu and Shan Zhou, undertake research projects of interest, build their track record and achieve a publication in a highly-regarded journal.

Upon completion, this project achieves good outcomes. This study contributes to the sparse empirical evidence on the real effects of IR. We document the potential unintended consequences of <IR> in inducing opportunistic earnings management behaviour, albeit only in countries where the capital markets are less developed. Our study highlights the importance of considering the sophistication of capital market development in assessing practice such as <IR> which can be more symbolic than substantive.

The results from this study send important message to the regulators that they need to be aware of the potential costs and benefits of <IR> in formulating regulations on <IR>. Our results provide evidence that in countries where <IR> is mandated, we observe a decrease in earnings management using discretionary accruals, without a significant increase in real earnings management, lending support to making <IR> a mandatory practice. In the meantime, we highlight that the unintended consequences of inducing opportunistic earnings management behaviour is most evident in countries where the capital market is less sophisticated.

For users of corporate reports, they benefit from our findings to learn that the quality of <IR> reports serves as a good signal for firms' underlying earnings characteristics which is less observable, and it is important to consider the capital market sophistication when doing so.