Essay: Can companies create value through reporting?

Posted by Rory Sullivan [1] on Apr 26, 2011

Rory Sullivan explains some questions investors ask and suggests how data generated for corporate responsibility reports can help answer them

For a long time, mainstream investors paid relatively little attention to corporate responsibility. While investors, in the round, understood why companies were spending time and resources on managing their social and environmental impacts, it is probably fair to say that their active interest was confined to situations where a major accident or scandal hit the headlines.

This has changed dramatically. More than 700 large investment institutions (asset managers and pension funds) have signed the UN-backed Principles for Responsible Investment and similar numbers support the Carbon Disclosure Project.

It can plausibly be argued that “responsible investment” – a general shorthand for the view that investors should take account of environmental, social and governance issues in their investment processes, and should encourage companies to improve their reporting and performance on these issues – has now become mainstream investment practice.

Yet, for all the interest and support from investors, we have reached an impasse on corporate responsibility reporting. Despite many companies identifying investors as one of the critical audiences for their corporate responsibility reports, most investors see these reports as irrelevant to their investment decision making.

This has led to frustrations on both sides. Investors are accused of not paying sufficient attention to how companies manage their environmental and social performance. Companies are accused of pushing out information that not only has no immediate relevance to investors but also seems to have no relevance to the key business challenges that these companies face.

At its heart, the problem seems to be a lack of understanding on both sides. Not only are companies making assumptions, often ill-founded, about what investors are really interested in, but investors seem to be singularly poor at explaining how they use corporate responsibility information in their investment decisions.

And so, the aim of this essay is threefold. First, to explain what responsible investment looks like in practice. Second, to explain what this means for the way in which investors use corporate responsibility information. And third, to offer some practical proposals on how corporate responsibility reporting can be made more useful to investors.

Understanding investors’ interests

There are various reasons for investors to pay attention to environmental and social issues in their investment practices. These include:

- the potential for improved returns (eg through benefiting from themes such as renewable energy, through identifying risks that more conventional forms of financial analysis may not identify, or through reducing risk by ensuring higher standards of corporate responsibility performance);
- meeting the demands of clients, government, trade unions and non-governmental organisations for investors to play a more active “ownership” role in the companies in which they are invested; and
- the potential brand and reputation benefits from adopting a proactive approach on these issues.

While the broad arguments for investors to look at corporate responsibility performance are clear, responsible investment is nothing like a homogeneous discipline. The reality is that, as illustrated in table 1, the term responsible investment encompasses a variety of investment strategies and philosophies, with very differing views on the weight that should be given to particular environmental or social issues, and to the uses that corporate responsibility information can be put.

Among individual investment managers, it is not uncommon to find a variety of strategies with a wide divergence in the weight given to environmental and social performance, the uses to which corporate responsibility information is put and the specific data points that are taken into account.

Reporting issues

Despite the many thousands of corporate responsibility reports produced each year and the major progress that has been made in developing standardised indicators (such as, for example, the work of the Global Reporting Initiative) and reporting tools (eg the AccountAbility AA1000 series on assurance), corporate responsibility reporting remains unsatisfactory in the eyes of many investors.

Common criticisms are:

- Corporate responsibility reports are inconsistent in scope and content.
- Companies have a “pick and mix” approach to the indicators on which they report, and these indicators frequently change every two or three years. This means it is difficult to properly assess the overall trends in a company’s performance and even more difficult to compare companies.
- Reporting tends to focus on good news rather than provide a properly balanced assessment of performance.
- There are uncertainties in the data provided in corporate responsibility reports and these uncertainties are rarely acknowledged or quantified.
- The business implications of social and environmental issues are not discussed. It is relatively unusual for companies to explicitly discuss the implications (if any) of environmental and social issues for the company’s strategy or key value drivers.
- It is frequently difficult to assess how companies are performing against their own corporate responsibility policies and commitments.
- It is not clear what resources (human, financial, etc) have been allocated for the achievement of

the company’s corporate responsibility objectives.

- The processes for assessing materiality (or financial significance) are rarely transparent.
- Companies do not explain what has been excluded from the scope of reporting. Nor do they explain the implications of these exclusions for the numbers and data reported.

The result is that the theoretical potential of corporate responsibility reporting remains unrealised. Investors are reluctant to rely on the data presented for financial modelling. It is difficult if not impossible to make meaningful comparisons between companies. And the credibility benefits that should accrue to companies that have a proactive approach to corporate responsibility have proved elusive.

Communication challenges

The limits and inconsistencies in corporate responsibility reporting affect all companies, both those that produce excellent reports and data, and those that do not.

The answer is not as simple as saying that companies should report using a standard reporting protocol or report against a standard list of indicators. Companies, in fact, face a number of fundamental challenges.

First, they need to communicate with a range of parties, not just investors. Employees, customers, civil society organisations and governments are all important audiences for information and companies need to balance the needs and interests of these different parties in their reporting.

Second, companies are not homogeneous and standard reporting protocols such as those produced by the Global Reporting Initiative (GRI) may not be directly applicable to their operations. This problem is compounded by the fact that at least some companies wish to differentiate themselves on the basis of their corporate responsibility activities, and standard reporting protocols may not allow them to do this effectively.

Third, companies face resource constraints and, inevitably, need to make trade-offs between the information that is requested and what they can actually provide.

Fourth, and with good cause, companies frequently complain that the information they do provide is ignored or, worse, taken out of context to present a misleading picture of the company and its activities. This means there may be limited incentive for companies to improve their reporting.

The reality is that it is very difficult (if not impossible) for companies to produce a report on their corporate responsibility performance that meets the interests of all their investors, let alone the needs and interests of other stakeholders. Yet there is much that companies can do within the confines of their existing reporting processes to enhance investor understanding of their business.

To do this requires that companies understand how investors actually use (and, perhaps more importantly, don’t use) corporate responsibility information in practice. In very broad terms, investors will be interested in different things when they consider those issues that are financially material and those that are not.

For financially material issues (ie those issues that can affect a key financial indicator by at least 5% or 10% over one or two years), investors will want to know whether and how these issues will affect a company’s strategy, cash flows, profits or balance sheet. For these issues, investors will tend to pay much more attention to how the company intends managing the issue (management systems and controls, capital and operating expenditures, R&D, etc), the performance measures and targets set by the company for the issues in question, and the company’s performance against these performance measures and targets.

Most companies will have relatively few, if any, social or environmental issues that are financially material against the definition above. For other issues (ie the majority of issues that get covered by the corporate responsibility label), investors are much less likely to examine them in detail but they will be interested in ensuring that these issues are effectively managed and unlikely to create significant risks to the business. For these issues, there is a striking degree of consistency across investor-backed disclosure frameworks such as the Carbon Disclosure Project around the type of information that companies should provide.

Investor expectations

Investors generally expect companies to provide:

- Information on the company itself to put its social and environmental impacts into context.
- A clear statement on the financial implications of environmental and social factors for the business, including issues that are considered financially material. If corporate responsibility-related risks are not considered financially material, this should be explicitly stated.
- A description of the company’s governance and management arrangements for environmental and social issues. This covers questions such as: whether there is a board or senior management committee responsible for oversight of the company’s corporate responsibility strategy; whether there is a senior manager who is responsible for implementation on a day-to-day basis; and, whether the company’s management systems have been certified to a recognised standard such as ISO’s specification for environmental management systems.
- A list of major social and environmental risks and impacts, including an explanation of how these have been assessed and prioritised.
- Details of the company’s policies on the issue(s) in question.
- Details of the actions it intends taking to manage the issue(s) in question.
- Its targets and key performance indicators for the issue(s) in question.
- An assessment of its performance against its targets and key performance indicators. This should include discussion of the factors that have affected its performance.
- Forward-looking information on how the company expects its performance to evolve over time and the key factors (changes in the business environment, public policy and regulation, consumer trends, stakeholder pressures, etc) that will affect performance.

While the degree of consistency in the messages being sent from investors to companies is encouraging, there are two important caveats.

First, there is limited consensus on the performance data that should be reported. This relates not only to the headline performance measures (such as total greenhouse gas emissions) but also to the supplementary information and data required to put this type of number into context. This is a work in progress. We have seen significant advances in particular areas, notably climate change and corporate governance, but in many areas the key data and indicators that are likely to be most useful to investors are still being developed.

Second, given that the needs and interests of investors are not homogeneous, companies will still find that they have to provide additional information to different investors. The reality is that it will be virtually impossible for a company to produce a corporate responsibility report (or equivalent) that satisfies the information needs of all of its investors.

Where we are

We are at an interesting and exciting point in the evolution of corporate responsibility reporting. There is a growing interest among investors in how companies manage their corporate responsibility issues and in using corporate responsibility performance information in investment research and decision-making.

While the information in corporate responsibility reports remains some way from being fit for these purposes, the fact that investors recognise the value of higher quality information is a clear demonstration of the progress that has been made.

It also represents a major opportunity for companies: the provision of high quality and relevant information that is clearly linked to corporate strategy and performance should help overcome the all too common dialogue of the deaf between companies and investors on corporate responsibility performance.

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