The Real Value Of Non-Financial Reporting On Sustainability Performance By Companies

By Wayne Visser

The popular maxim "the business of business is business" distils a powerful and still prevalent belief that companies need to stay focused on profit making and return to shareholders and not become too distracted by peripheral activities like social responsibility or environmental concerns. Indeed, the American economist Milton Friedman went so far as to say, in 1970, that "the social responsibility of business is to increase its profits".

But this doctrine of shareholder-driven capitalism has come under increasing scrutiny in recent years. The first fundamental challenge came in 1984 with the introduction by Ed Freeman of the concept of corporate accountability to 'stakeholders' – so-called 'interested and affected parties', like employees, communities, suppliers and even future generations – which has subsequently been enshrined in many corporate governance codes and business mission statements.

Harvard professor Michael Porter, famous for his work on competitiveness, went further in 2011, declaring that "the capitalist system is under siege. In recent years business has been criticized as a major cause of social, environmental and economic problems … A big part of the problem lies with companies themselves, which remain trapped in an outdated, narrow approach to value creation. Focused on optimizing short-term financial performance, they overlook the greatest unmet needs in the market as well as broader influences on their long term success."

Business leaders may argue – and not without justification – that financial performance is what the market demands and what their share price and job security depends on. But the market is changing. As 'non-financial' issues like resource security, climate change, human rights and corruption become more serious global problems, they become, to use the jargon of accountants, more 'material', meaning that they can significantly affect business continuity and financial performance.

For example, research by KPMG shows that the total environmental costs as a percentage of earnings (EBITDA) are high in many sectors: 224% for food producers, 87% for electricity, 64% for mining, 59% for marine transportation, 43% for chemicals, 42% for beverages and 22% for automobiles. Currently, they are not required to pay for these full costs (to 'internalise their externalities' as the economists call it), but policy makers are looking for ways to change this.

To begin with, more and more governments are making it mandatory to disclose non-financial information. 2016 research identified almost 400 regulations, guidelines, codes-of-conduct, frameworks and other reporting instruments – both mandatory and voluntary - across 64 countries, up form 180 instruments across 44 countries in 2013. This includes, for example, the European Commission requirement for companies to disclose relevant and useful information on environmental and social matters, according to its 2014 Directive on disclosure of non-financial and diversity information.

Besides these legal trends, voluntary sustainability reporting has been growing every year, with 10,865 companies having issued 42,000 non-financial reports, of which 27,570 were prepared in accordance with the GRI Sustainability Reporting Guidelines. In order to make this expanding database more accessible, platforms like the EU-funded WikiRate are using crowdsourcing and cross-sector collaboration to 'liberate the data', allowing anyone to benchmark a company's environmental, social and governance (ESG) performance.

ESG data is of particular interest to fund managers, index owners and financial analysts engaged in the growing market for responsible investment. For example, the Carbon Disclosure Project includes a network of investors and purchasers, representing over $100 trillion, who are concerned about climate change. The UN Principles for Responsible Investment now have around 1,800 signatories, representing $65 trillion in assets under management and globally there are now $22.89 trillion of assets being professionally managed under responsible investment strategies, an increase of 25% since 2014.

One of the main drivers of this trend towards responsible investment is that poor non-financial performance is increasingly associated with significant financial risks. For example, BP lost 50% of its value in 50 days following its Deepwater Horizon spill in the Gulf of Mexico, and it has cost the company $61.6 billion since 2010. Similarly, Volkswagen's provisions for the 'dieselgate' cheating scandal rose to €22.6 billion, making it the worst crisis in the company's history.

More generally, Citigroup analysts predict that there are $US100 trillion of potential 'stranded assets' in the fossil fuel industry. This represents the value of the fossil fuel reserves that need to be left in the ground if the world is to meet its targets of trying to limit global warming to 2°C, a goal agreed in the Paris Climate Agreement by all but three of the world's countries.

Conversely, better sustainability performance is increasingly associated with better financial performance. For example, the FTSE4Good Global Index – designed by the London Stock Exchange to measure the performance of companies demonstrating strong Environmental, Social and Governance (ESG) practices – has significantly outperformed the FTSEAllShare Index over the past 5 years. FTSE4Good and other similar ethical indexes like the Dow Jones Sustainability Index all require corporate ESG data in order to make credible assessments of their potential future value.

Hence, the interest by market analysts and investors in sustainability performance data is driven not only by the risks associated with poor performing companies, but also the growth opportunities associated with sustainability leaders. For instance, in 2017, the Business & Sustainable Development Commission claimed that sustainable business models could open economic opportunities worth up to US$12 trillion and increase employment by up to 380 million jobs by 2030.

The challenge for business – and the accounting and financial professionals that they rely on – is to capture the inherent value of sustainability performance in an accurate and timely way. The International Integrated Reporting Framework was a first attempt at such a project, to encourage companies to begin measuring and reporting on value creation (or destruction) across six capitals: financial, manufactured, intellectual, human, social and natural capital.

More recently, the Future-Fit Business Benchmark has tried to give companies practical guidance by identifying the environmental and social performance thresholds that all companies must ultimately strive to reach, and a way to assess progress toward them. Meanwhile, KPMG's True Value methodology has been designed to help companies to measure its 'externalities' (positive and negative economic, social and environmental impacts) and express these in financial terms that the market can understand.

We are at the threshold of a revolution in the way we conceive of and measure value. I call it the trend towards creating integrated value, which is starting to give us a way to factor social and environmental risks into investment decision making – and more importantly, to catalyse the creation of new value by companies by finding synergies between business models that are smart, safe, shared, sustainable and satisfying.

Article reference

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