Sustainability and Integrated Reporting for Sustainable Corporate Strategies

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Sustainability and Integrated Reporting for Sustainable Corporate Strategies

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ABSTRACT

Sustainability has different significance, importance and meaning to different individuals and corporations. Recently, however, there has been a growing public consensus on the importance of sustainability for both companies and investors. This report summarizes the public lecture delivered by Dr. Robert G. Eccles,[1] which was based on his book The Integrated Reporting Movement: Meaning, Momentum, Motives, and Materiality, co-authored with Michael P. Krzus. The lecture discussed the perception and value of sustainability for both companies and investors by briefly presenting several empirical studies and reports. It then traced the United Nations Global Compact and the Sustainable Development Goals initiatives and examined the main barriers and opportunities for them to be successful. Finally, it concluded by explaining the framework of integrated reporting and its concept of materiality, which is the essence of achieving sustainable development.

INTRODUCTION[2]

Dr. Robert G. Eccles started his lecture by introducing his recent book The Integrated Reporting Movement: Meaning, Momentum, Motives, and Materiality, which he co-authored with Michael P. Krzus. The lecture was divided into three parts:

- Companies' perspective. Since external stakeholders, be it investors or ordinary people, are interested in companies, what sustainability means from the company perspective.

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1 A former tenured professor at Harvard Business School, and now a visiting professor of management practice at the Said Business School at Oxford University and a visiting lecturer at MIT.

2 Disclaimer: The views expressed in the Center for Islamic Economics and Finance lectures and seminars reports are those of the author(s) and do not necessarily reflect those of the CIEF or Hamad Bin Khalifa University. These reports have not undergone any formal review and approval process. The purpose of disseminating these is merely to make them available to a wider audience. For personal use, these reports can be downloaded.

- Investors' perspective. Sustainability from an investment perspective, along with observations and studies providing empirical data.
- Materiality. A concept that is the essence of understanding sustainability and sustainable development.

COMPANIES' PERSPECTIVE

An increasing number of scholars, as well as private sector leaders, Sustainability has different meanings to different people. For some people, it is caring about the environment, green technology and tree planting; for others, it is an irrelevant new trend. However, for the most part, public consensus is building that sustainability is important from both a company and investor perspective. Within the scope of Dr. Eccles' lecture, sustainable corporations and sustainable strategies had the following key elements:

1. Long-term orientation;

2. Involvement of board members to understand what sustainability is;

3. Strategically focusing on environmental, social and governance (ESG) issues that are the most material and that impact a firm's ability to create value over the short, medium and long term.

It is crucial to distinguish material ESG issues, which are important characteristics of a sustainable corporation through a sustainable strategy. Most European and US companies are involved with community projects and carbon reduction programs. They have sustainability strategies, including specially created sustainability groups within the company, along with a chief sustainability officer or a corporate social responsibility officer and appropriate allocated budget. These are good indicators of development towards sustainability. However, most of these strategies are not concentrated on the issues that are central to a company's strategy and could affect companies' value creation ability over the long term. A "sustainability strategy" is much less than a corporate "sustainable strategy." The latter is about the material issues for investors, and the former is about socially significant issues that are important to stakeholders since companies' licenses to operate come from civil society. Furthermore, unless a company's investors have a solid understanding of material issues, the company will not be able to leverage the capital market to support its long-term value creation potential.

Empirical Study on Environmental, Social and Governance (ESG)

A collaborative meta-study between Oxford and Arabesque Partners of over 200 papers showed that 85% of the world's 250 largest companies report on sustainability. Some 90% of studies reported that ESG leads to lower cost of capital, 88% to better operational performance, and 80% to better stock price performance, which means that sustainability leads to higher financial returns[3].

The Study of Buy – and – Hold Stock Returns

What is the evidence that supports corporations focusing on ESG issues reporting better financial performance?

Using data from a variety of sources from 1990 to 2010, twin sets of companies – higher sustainable companies and lower sustainable companies – were matched up and analyzed. Specifically, 95 high sustainability companies from a range of industries were matched with 90 low sustainability companies of the same kind in terms of similar industries, capacity, structure and financial performance.

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3 Gordon Clark, Andreas Feiner, & Michael Viehs, (2015), "From the Stockholder to the Stakeholder", https://yoursri.com/news/arabesque-partners-and-oxford-university-update-sustainability-meta-study

The main focus points were their characteristics and financial returns. The characteristics were interesting. These two sets of companies behaved very differently. The higher sustainability companies were more transparent in their external reporting, used a wider range of factors of environmental performance, provided more non-financial information, compensated their executives on a wide range of performance metrics (not just financial performance), and were much more active in terms of stakeholder engagement. In general, these companies were operating and being managed in a different way from what has been the basic operating model since the Industrial Revolution.

Importantly, they also performed better financially. Both sets of companies indicated similar performance for about five to six years. The superior financial performance of the sustainable company sample did not start immediately; the other side of ESG integration is the necessity to have a long-term view. For instance, in the West, one of the complaints companies have is that investors are only looking for short-term performance, so when they invest in corporate sustainability, they put themselves at a disadvantage. However, several great initiatives in the US are trying to change that relationship between large companies and large investors.

Reporting is an important part of this. Data provided by the Global Reporting Initiative indicates that companies have come to recognize the importance of sustainability reporting. Starting with approximately 12 companies reporting on sustainability voluntarily in the 1990s, which in 2015 became a sort of a standard, the number of companies voluntarily reporting on sustainability now totals more than 5,400.

INVESTORS' PERSPECTIVE

While companies have been dealing with sustainability and ESG issues for a considerable period, investors, as well as big asset managers, took a relatively neutral position on these matters until recently. The investor position regarding sustainability has changed dramatically over the past two years. As recent movements indicate, in August 2017, a large California pension fund published a policy that covered their five-year plan for ESG integration across all asset classes. It is economic self-interest for their beneficiaries that is driving this.

The United Nations-sponsored Principles for Responsible Investment (PRI) is an international network of investors working together to put the principles of responsible investment into practice. The PRI database, which includes 1,500 signatories representing $60 trillion in 50 countries around the world, is intended for asset owners and asset managing service providers. While they have six main principles, Dr. Eccles highlighted three of them:

1. Incorporating ESG issues into investment analysis and decision-making processes;
2. Incorporating ESG issues into ownership policies and practices;
3. Seeking appropriate disclosure on ESG issues by the entities in which the group invests.

4. EMPIRICAL STUDIES

Interesting results have been achieved with the help of an MIT study on sustainability that included both companies and investors:

- 75% of investment firm senior executives agree that sustainability performance is materially important;
- 75% cite improved revenue performance and operational efficiency from sustainability as strong reasons to invest;
- Half of investors will not invest in a company with a poor sustainability track record, whereas 60% are prepared to divest if sustainability performance is poor;

- There is a lack of communication between corporations and investment firms;
- Only 44% of companies and 36% of investors consider inclusion on a sustainability index as an important investment decision factor.

Although a sustainability strategy is considered to be important, only 60% of companies have developed one, and only 25% confirm that a business case has been developed. The issue of being able to measure, report on and understand the relationship between non-financial ESG performance and financial performance is important. The survey that studied 582 global institutional investors indicate that two-thirds of them gave a positive answer to the question: "Is it possible to demonstrate the financial value of managing in EGS issues?"

According to a Eurosif SRI study of socially responsible investing (SRI) strategies, there are seven types of SRI strategies: [4]

- Exclusion (negative screening), which is considered the first step in responsible investing or sustainable investing;
- Norm-based screening, a central figure in the screening of companies in terms of to what extent the principles of targeted companies reflect the principles established by global organizations;
- Engagement and voting, which is actively engaging and actively voting by the companies;
- ESG integration, which is considered to have a bright future, although one of the constraints on ESG integration is data reporting by companies;
- Sustainability themed, which means the investment is made in a company that is focused on a particular problem;
- Best-in-class investment selection;

4 Eurosif SRI Study (2018), http://www.eurosif.org/sri-study-2018/

- Impact investing, which is concentrated on two goals: 1) having a financial return; 2) making an impact on sustainability in the world. So far impact investing, whether private investing and venture capital, have been project-focused or focused on particular social things only, which is not bad yet there is a room to grow.

UNITED NATIONS GLOBAL COMPACT

The United Nations Global Compact is an initiative to encourage businesses worldwide to adopt sustainable and socially responsible policies and to report on their implementation. The UN Global Compact is a principle-based framework for businesses, stating 10 principles in the areas of human rights, labor, the environment and anti-corruption. Currently, it compromises 8,000 voluntarily signed companies and more than 4,000 non-business organizations, and includes the requirement of filing an annual communications on progress report. The Compact does not prescribe how the report should be filed – whether in the form of a sustainability report or within an annual report. The aim is to change the behavior of companies by having identified norms and principles. PRI is aiming to achieve sustainability by changing the behavior of investors.

Sustainable Development Goals

The 17 Sustainable Development Goals (SDGs) of the 2030 Agenda for Sustainable Development have been signed on by UN member states. However, they are not binding. The number of goals is large, and important questions arise, such as: Can all of these goals be accomplished, or are there trade-offs? And if there are trade-offs, what if they are between social issues and environmental issues?

A study that investigated the most interesting SDGs for investors concluded that the SDGs could be divided into three categories: the top five goals; medium seven goals; and bottom five goals.

- Top five goals: industry, innovation and infrastructure (9); decent work and economic growth (8); climate action (13); affordable and clean energy (7); quality education (4)
- Medium seven goals: good health and well-being (3); responsible consumption and production (12); gender equality (5); life on land (15); peace, justice and strong institutions (16); clean water and sanitation (6); zero hunger (2)
- Bottom five goals: reduced inequality (10); sustainable cities and communities (11); life below water (14); no poverty (1); partnership for the goals (17)

The biggest investors are concerned about the systematic risk in regard to reduced inequalities, which is goal number 10 from the bottom five category. What are the things which cannot be diversified? What are the things that negatively impact a stable market at the global level, which will make it difficult to get a return on investment? From the investors' perspective, inequalities (gender, income, etc.) are considered to greatly increase issues at the systemic level.

Main Barriers for Investors

Most studies show that the main barriers for investors focusing on SDGs are a lack of data showing the relevance of the SDGs to investors (cited as a barrier by 66% of respondents), the wide-ranging nature of the SDG framework (cited by 57%), and insufficient investee company transparency on ESG issues (cited by 55%). However, the inclusion of non-financial reporting is already starting to be incorporated into annual reports and will take time to be accepted by the majority of companies, since financial reporting, which is now taken for granted, did not always exist. Accounting standards (US GAAP, IFRS) and financial reporting requirements came into existence as initiatives to protect investors through transparent and comparable information on company performance.

Islamic Development Bank as Islamic Finance's Main Contributor to the SDGs

The Islamic Development Bank (IDB) has already produced a report on the role of Islamic finance in the SDGs. The SDGs that the IDB selected as its main focus were the following goals: no poverty (1); zero hunger (2); good health and well-being (3); gender equality (5); clean water and sanitation (6); affordable and clean energy (7); industry, innovation and infrastructure (9); sustainable cities and communities (11); and peace, justice and strong institutions (16).

The biggest questions regarding Islamic finance are how large it is today and how fast it is growing. It is essential to know the value of assets Islamic finance is managing to determine how big of an impact Islamic finance can have on sustainability.

What is the relationship between ESG (sustainable finance) and Islamic finance? The only common approach is negative lists/ exclusions, whereas there are several differences. However, if the differences are analyzed in detail, zakat/distribution to the needy is the only self-standing difference, whereas avoidance of debt/ leverage as well as instruments linked to real assets are considered in ESG by default. Nevertheless, deeper research on the principles of Islamic finance and how they relate to sustainable finance is worth pursuing.

INTEGRATED REPORTING

The International Framework, a principles-based, 40-page document, was published in 2013. Integrated reporting is commonly misunderstood as combining a financial report and a sustainability report. However, its main goal is to communicate to investors a company's strategy and plans for creating value over the short, medium and long term.

We would not have the capital markets we have today without financial reporting. Nonetheless, these capital markets need to change to support sustainable development, and integrated reporting has an important role to play in making this happen. Through an integrated report, a company explains how its financial and non-financial performance are related to each other.

Materiality

Materiality is a fundamental concept in all forms of reporting. In financial and integrated reporting, a piece of information is material if it would be of interest to investors. A report filled with immaterial information creates noise. Different groups and organizations such as the US Supreme Court, SASB, GRI, CDP, Accountability, IIRC, IASB and FASB have all given guidance on materiality. In the US, the Supreme Court and the Securities and Exchange Commission define materiality as a piece of information that has material importance which will influence reasonable investors' decisions.

What is needed is guidance on the materiality for non-financial information. The International Integrated Reporting Council notes the importance of materiality but relies upon standard setters for both financial (e.g., FASB and IASBl) and non-financial (e.g., GRI and SASB) information to give the deeper guidance needed.

Sustainability Accounting Standards Board Provisional Standards

What the Sustainability Accounting Standards Board (SASB) has done is, in fact, important: it has recognized that what is material from the investor point of view varies by industry. Each industry has its subset from the full list of ESG issues that is material. For instance, for a chemical company, carbon emissions and energy usage are material. From a bank's perspective, carbon emissions are not material; how banks manage systematic risk is material. From a pharmaceutical company's perspective, access to medicine and safety in clinical trials are material. SASB developed 10 sector classifications subdivided into 79 different industries. Industry working groups comprised of companies, investors, intermediaries and experts have determined the material issues for each industry.

SASB has published the material issues for all 79 industries as well as the recommended key performance indicators for reporting on them. If these recommended key performance indicators are adopted either on a voluntary basis or a regulatory basis, it will enable internal and external stakeholders to have the same quality of comparable non-financial information as financial information. This will speed up the adoption of sustainable strategies by companies, which, in turn, will speed up sustainable investing by investors since they will have the data they need.

CONCLUSION

Dr. Eccles concluded his lecture by providing empirical data and analysis and his expectations for the future for the West and the Middle East, the Gulf region in particular. GE's First Integrated Report, published in 2015, was also highlighted. The lecture ended with a lively question and answer session, the exchange of ideas, and the reactions of participants to the key issues highlighted during the lecture.

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Speaker’s Bio:

Robert G. Eccles is a Visiting Professor of management practice at Saïd Business School. He was previously a Professor of management practice at Harvard Business School. Dr. Eccles is the world’s foremost expert on integrated reporting and a leader on how companies and investors can create sustainable strategies. He is the Founding Chairman of the Sustainability Accounting Standards Board (SASB) and one of the founders of the International Integrated Reporting Council (IIRC). He has recently joined the board of the Mistra Center for Sustainable Markets (MISUM) in Sweden. In 2011, Dr. Eccles was selected as one of the Top 100 Thought Leaders in Trustworthy Business Behavior, for his extensive, positive contribution to building trust in business, and in 2014 and 2015 was named as one of the 100 Most Influential People in Business Ethics. He is also an Honorary Fellow of the Association of Chartered Certified Accountants (ACCA). Dr. Eccles received Bachelor’s degrees in mathematics and in humanities and science from the Massachusetts Institute of Technology (both degrees in 1973) and a Master’s (1975) and a PhD in sociology (1979) from Harvard University. He joined the faculty of Harvard Business School that year and received tenure in 1989.