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the inside track #26

Highlighting CSR Issues of the moment

Materiality – what's it all about?

Effective corporate reporting should "tell the strategic story", as we have said before. But, several recent legislative events re-open the discussion about companies' reporting.

These include the requirement for a description (and definition) of business models and the relevance of materiality in determining the contents of reporting, especially for environmental, social and governance information (ESG).

The UK Corporate Governance Code introduced the phrase "business models" in the context of company reporting. This took effect for annual reports for financial years beginning after 29th June 2010. It required companies to be effective in telling the strategic story and defining the business model within Business Reviews. The effective date means most companies have just completed their first report under these requirements. Some do not adequately describe their business model. A common problem would appear to be that the materiality of what is included needs greater consideration.

Since then, there have been two consultations by BIS (Department of Business, Innovation and Skills) on the future of narrative reporting. The findings of the latest were published recently. These concluded there should be a split between a Strategic Report and the Directors' Statement, with the former including commentary on the business model and company strategy, together with ***material*** non financial environmental and social (to include gender diversity and human rights practices) information. Simultaneously, BIS has developed a requirement for more extensive remuneration reporting.

BIS continues to consult on the future of narrative reporting, but it seems reasonably certain that the Strategic Report will be introduced; with final proposals expected around early autumn.

What surprises is the convergence of opinion on the importance of the business model and materiality, in the context of sustainability in other spheres. Both the 2012 Dow Jones Sustainability Index (DJSI) submission and the Carbon Disclosure Project (CDP) submission now focus on the importance of demonstrating alignment between sustainability actions and business success.

The DJSI is recognised as a robust tool from which investors can assess companies' sustainable performance. This year it has changed about 14% of questions – a significant modification in their methodology. Specifically they seek evidence of alignment - "For this year, we will for the first time open up one question for companies to directly provide us information on how they are making the link between sustainability and financial materiality in both sustainability reports and financial reports (integrated reporting)."

The CDP, established originally to provide investors with data on companies' emissions, has asked previously about the extent to which climate change is built into a company's business strategy. However, this year it also asks for information about climate change initiatives implemented during the prior year, and requires information about monetary savings, investment required and payback periods. This additional investment oriented requirement takes climate change into the business process, rather than merely looking at emissions' savings.

Both examples demonstrate the use of very similar language to that of the legislative arena. This suggests that corporate reporting needs to focus on the material aspects of environmental and social reporting, by which we mean it should demonstrate that initiatives contribute to business performance improvements and business success over both the short and the longer terms.

However, how do auditors interpret "materiality", especially for annual reports? Traditionally, they used quantitative estimates assuming reasonable investors would not be influenced in investment decisions by fluctuations in net income of 5% or less. Would any non financial information be considered "material" for annual reports on this basis?

The challenge is how boards view the materiality of ESG initiatives. This impacts on how professional managers in these fields communicate the added value they provide to their companies.

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These legislative and investor driven developments demonstrate how corporate responsibility and sustainability are changing in the business community. They also align with some quite enlightening academic studies - suggesting academic, legislative and investment thinking is converging.

In previous work, we observed studies of correlation between non financial activities and business performance. A research paper we published with The Work Foundation[1] included the research study "From People to Profits" which demonstrated a positive correlation between employee satisfaction, customer satisfaction and revenue. In a chapter we wrote for a recent book, "Environmental Alpha"[2], we reviewed the research undertaken by New Amsterdam Partners, a New York based asset management firm. The findings from this research showed that better governance practices are reflected in stock out-performance in the nearer term, whereas better environmental practices result in stock out-performance in the longer term.

Whilst these studies were significant, there was a need for a stronger academic study, with a distinguished pedigree. This need may have been fulfilled by a recent study[3], compiled by academics from London Business School (LBS) and Harvard Business School (HBS). The study considered the extent to which ESG approaches within companies deliver better financial and share performance. It utilised DJSI data for nearly 200 companies over a 20 year timeline. Their findings demonstrated strong positive correlations showing that High Sustainability companies significantly outperform their counterparts over the long-term, both in terms of stock market and accounting performance. It found also that High Sustainability companies featured characteristics that included:

- senior level accountability for sustainability
- senior executive incentive schemes likely to include sustainability metrics
- having organised stakeholder engagement programmes
- more long-term oriented
- exhibit better measurement and disclosure of non financial information.

The longevity of the study coupled with the very high standing of LBS and HBS make it a very credible contribution to understanding how non financial activities can contribute to develop business success and performance improvement.

We invited clients to meet one of the study's authors, Ioannis Ioannou from LBS. We sought insight from corporate practitioners regarding three questions:

- how effectively are sustainability policies and practices communicated to shareholders and investors;
- how do companies demonstrate alignment between ESG and sustainability strategies;
- how do investment intermediaries perceive, interpret and evaluate corporate communications related to sustainability?

Conclusions from the group discussion demonstrated that corporate responsibility and sustainability practitioners need to focus more on demonstrating their activities' and initiatives' added value (i.e. are material). With this in place, demonstrating that initiatives align with business success and performance improvement should enable them to better gain senior management's positive commitment. They, in turn, would be able to more persuasively communicate these matters to investors, demonstrating their relevance and value added.

Undoubtedly some legislation will confound the principle of materiality – DEFRA's requirement for the mandatory reporting of greenhouse gases (GHGs) is one example, although it is currently on hold for the time being. Similarly, there is still the possibility that the EU may wish to introduce legislation related to CSR, but this seems a little way off.

Nevertheless, there is a sense that legislation and academic studies are converging in a manner that relates to good business and investment practice in a positive manner. It will force practitioners in the field to take on a more business minded approach than they may have done previously. The approach that will emerge may not be so satisfying to some (like more extreme NGO observers), but by being based upon added value and business materiality senior executives should become more committed to material non financial activities.

[1] Achieving High Performance: CSR at the heart of business 2004

[2] Environmental Alpha: Institutional Investors and Climate Change – Wiley Finance 2009

[3] The Impact of a Corporate Culture of Sustainability on Corporate Behavior and Performance - Working Paper 12-035 Robert G. Eccles, Ioannis Ioannou, George Serafeim - http://www.hbs.edu/research/pdf/12-035.pdf

If you would like to know more about materiality in business review reporting, and would like an objective and impartial view, contact Tony Hoskins or Melissa Kittermaster via thoskins@thevirtuouscircle.co.uk

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