Corporate Reporting: New Wine, New Bottles

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April 2005

A quiet renaissance in corporate reporting is gradually transforming its purpose, content and readership. This transformation predates the recent spate of accountability misconduct, but is accelerating because of it. In a few short years, a new generation of reports will have moved from the extraordinary to the exceptional to the expected, thereby establishing a new standard of transparency unimaginable even a decade ago. For forward-looking managers, opportunities abound to stake out leadership positions among investors, employees, customers, and communities.

For a glimpse of next-generation disclosure, browse the 2002 Report of global pharmaceutical firm Novartis entitled *Caring and Curing*. At first glance, it looks like business-as-usual, opening with a summary of financial and news highlights, CEO letter and anecdotes touting “Amazing Patient Stories.” But read on and the business-as-usual case starts looking not-so-usual. A section on “Corporate Citizenship” is followed by “Animal Welfare,” “Health, Safety and Environment”, and “Human Resources.” Next is “Corporate Governance”, with information on the Board, Executive Committee and Business Unit Heads, with specifics on compensation, audits, committee structure and other governance issues that continue to headline business pages of the mass media. Finally, the “Financial Report” appears, including Operating and Financial Review, Equity Strategy and Share Information, and financial statements. The scorecard: approximately half of the 160-page report is devoted to non-traditional, non-financial information.

Novartis is not alone. The company’s decision to elevate non-financial reporting to a level equivalent to financial is unique to neither the company nor the sector. To be sure, it is partially a response to the intensive spotlight on critical issues such as drug pricing, customer access, patents and generics that appear in regular doses in the mass media. This, in turns has fueled investor concern about the viability of pharma’s business model in a world that demands greater equity in access and affordability of life-saving drugs. But this does not tell the whole story.

Consider the case of GKN, a $5.5 billion UK-based global automotive and aerospace engineering company. GKN integrates its “Social Responsibility Review” into its 2002 annual financial report. The review covers such topics as employment policies, ethics, education and training, community engagement, and health and safety, as well as energy, waste generation, and water. BC Hydro, the $4 billion Canadian electric utility, published its *2003 Annual Report: Reporting on the Triple Bottom Line Performance*, blending its financial performance with an array of social and environmental performance

indicators. DSM, the Dutch chemical company, integrates its financial and non-financial performance into a unified report. Likewise, the SAS Group, the Scandinavian airline, produces a unified financial/non-financial report, as does Natura, a leading Brazilian cosmetics firm.

These are not isolated cases. At least 2,000 companies worldwide (e.g. Agilent, DuPont, Ford, GM, Johnson & Johnson, Anglo American, BASF, SONY) are publishing stand-alone citizenship, sustainability, and environmental and social reports. Among these, a small but growing number, exemplified by Novartis and GKN, are merging their financial and non-financial disclosures. Some 650, a figure growing monthly and including all those firms referenced above, use the framework of the Global Reporting Initiative (GRI), the emerging international standard for non-financial disclosure. It is only a matter of time before unified financial/non-financial reports become standard business practice.

Drivers

Reporting and its parents—transparency and accountability— are the signature issues of the post-Enron area. Fueled by unrelenting news of accountability breakdowns and governance malfeasance, the march toward higher reporting standards is irreversible. Yet, while integrated reporting has been accelerated by the misconduct of a few companies, its roots are broader and deeper than the post-2000 scandals. More than a half century after the birth of modern financial reporting, it is becoming increasingly clear that incremental changes in corporate reporting under the aegis of national and international financial accounting boards is insufficient to correct the systemic weaknesses that persist. For companies failing to grasp this reporting transformation, disquiet among corporate stakeholders will intensify with each cycle of annual reports whose contents seem increasingly detached from the realities of 21st century determinants of value, risks and opportunities.

For investors, current reporting simply does not deliver adequate information on the intangible assets that today account for well over half the market's capitalization. Quality of management, knowledge systems, governance, social and environmental risks have yet to appear in consistent and rigorous fashion. Other stakeholders—consumers, employees, suppliers, and activists—grapple with the same information deficiencies. The few pioneering companies that are leading the reporting renaissance understand what the majority do not yet recognize: the utility of conventional financial reporting is increasingly disconnected from what stakeholders need and expect to make informed decisions.

Opacity Has Its Costs

The cost of deficient disclosure is greater than most companies realize. Evidence of such costs is traceable to the mid-1960s when, as recent research shows, over-the-counter markets saw a dramatic reduction in stock price volatility once mandatory disclosure standards were imposed. More recently, a 2002 Standard and Poor's analysis of the

disclosure practices of 1,500 companies found that the "…amount of information companies provide in their annual reports is correlated to the market risk and valuations," specifically, a higher price-to-book ratio and the ability to lower the cost of capital. In a similar vein, an assessment of 300-plus GRI reporting companies indicates a moderately positive correlation with lower share price volatility, higher operating profits, and revenue growth. Meanwhile, recent studies by McKinsey and Lipper indicate, respectively, investors' willingness to pay for strong governance practices and above average performance of portfolios containing well-governed companies.

No one of these studies yield conclusive evidence of the transparency dividend, or even the causal relationships between transparency and financial performance. But taken together, the weight of evidence decidedly points toward two conclusions: first, markets are using reporting practices as a proxy for quality of management; and, second, markets are beginning to reward disclosure practices that reach beyond the narrow confines of conventional financial reports.

Taking Advantage

For companies that play in global markets, it is not a question of "if" they should respond to these trends, but "how" and "when." Non-financial reporting is here to stay. If there is an element of choice, it is only between what Don Tapscott and David Ticoll call "active transparency" that is shaped to support company strategy versus "forced transparency" in which the firm's transparency strategy is largely crisis-driven and reactive to external stakeholders.

For managers, the choice is obvious. But shedding old habits rooted in defensiveness and opacity requires both vision and persistence. Here are the essentials for moving forward:

Benchmarking. Companies in virtually every sector—extractive, manufacturing and services—are now practicing non-financial reporting. Various web-based data sets, including GRI's (www.globalreporting.org) enable a quick identification of company practices, and an assessment of which firms are most mature and rigorous in this emerging field.

Leadership. CEOs need to take a stand. Integrated reporting offers an antidote to the loss of confidence in corporations documented in virtually every opinion poll in the last three years. Stepping up with both a commitment to and delivery of cutting-edge integrated reporting is key to restoring public trust. In the US and elsewhere, CEOs are being held accountable for financial statements. The same needs to happen, preferably by CEOs themselves initiating action, with respect to information on social, environmental and governance performance information.

Execution. Getting started and continuously improving reporting requires cross-functional involvement. In its best form, integrated reporting entails both shared responsibility and shared benefits. Product development, marketing, production, financial, environment, health and safety, human resources, community affairs and other

functions all have much to contribute and much to gain. Indeed, there is a direct correlation between the depth and diversity of internal investment in reporting and the business value reporting generates.

Engagement. Non-financial reporting requires engagement with non-financial stakeholders. Successful practitioners understand that absent systematic consultation with customers, activists, suppliers and investors, major issues will be missed and reports will be viewed as incomplete at best, or misleading at worse. A pharmaceutical company report that omits drug access, a mining company that omits HIV/AIDs, an energy company that omits climate change, or an apparel company that omits sweatshops will fail the test of credibility while squandering the resources it allocates to its reporting programs.

Monitoring. Integrated reporting is a fluid, fast-moving work in progress. New norms and measurement methods are appearing every month. OECD's Principles of Corporate Governance, the UN's Global Compact and *Norms on the Responsibilities of Transnational Corporations*, and GRI exemplify international initiatives that warrant the attention of any firm doing business in global markets. Actual or proposed revisions to UK Company Law, Canadian accounting standards, and US SEC environmental disclosures also are reshaping the reporting landscape. These kinds of initiatives represent an emerging body of practice that is gradually laying the foundation for the next generation of generally accepted disclosure practices.

Outreach. Realizing the full benefits of leading edge reporting requires strategic outreach to alert market intermediaries and other stakeholders of its existence and content. Rating groups such as Standard and Poor's, Fitch, and Governance Metrics, as well as institutional investors and key customers, are essential to making investment in innovative reporting pay dividends. Lower cost of capital, reduced share price volatility, and retention of major investors can be enhanced by regular communication about a company's integrated reporting progress and achievements.

The reporting renaissance is real, compelling and irreversible. It is a reality of doing business and retaining the license to operate in the coming decades. If wisely managed, it also is an opportunity to assert competitive advantage. Those firms that wait for the conclusive business case for integrated reporting are missing the opportunity to help restore and deepen what ultimately is every firm's most valuable asset—trust, in its management, products, and services. For laggards, stakeholder patience, sooner or later, will wear thin. For leaders, the future holds rich rewards.