Corporate governance and reporting

Summary

Event co-hosted by Cass Business School and Frank Bold
7 June 2017

Building on the results of the previous two seminars on directors' duties and systemic risks, held at Cass Business School on 7 June 2017, the 'Corporate governance and reporting' event focused on best practice and the desired development of reporting and accounting practice and policy. The participants engaged with corporate purpose, fiduciary duties, long-term and ESG risks and related these to new and evolving legislative requirements that aim to support long-term oriented governance, such as the EU Non-Financial Reporting Directive.

Speakers:

- Richard Howitt, CEO of the International Integrated Reporting Council (IIRC) (Keynote)
- David Cooke, Lawyer at ClientEarth
- Stephanie Hime, Director at Little Blue Research
- Yukako Kinoshita, Corporate Responsibility and EU Policy Research, Hitachi
- Charlotte Villiers, Professor of Company Law, University of Bristol
- Ladislas Smia, Deputy-head of Responsible Investment Research, Mirova
- Omar Selim, CEO, Arabesque Partners
- Jo Iwasaki, Head of Corporate Governance, Professional Insights, ACCA (Moderator)
- Paige Morrow, Head of Brussels Operations at Frank Bold (Moderator)

Initial notes

The form of corporate reporting used influences how corporate boards establish their targets and decide on the means to achieve them. Traditional company reporting requirements concentrate on financial reporting, consisting of the balance sheet, the profit and loss account and the notes.[1] Current accounting models do not address several issues that are essential for a corporation's ability to create sustainable value, in particular information about social and environmental risks and benefits, systemic risks, non-financial capitals and intangible assets.

In the past decade, there have been increasing requirements for non- or extra-financial reporting, albeit with limited provision for monitoring or enforcement, and insufficient connection to financial reporting. Most notably, between 2014-2017 EU Member States transposed into national law the EU Non-Financial Reporting Directive, which requires that large listed and financial companies include in their annual management report certain information on environmental, social, human rights and anti-corruption matters.[2] In the UK, the transposition took the form of The Companies, Partnerships and Groups (Accounts and Non-Financial Reporting) Regulations 2016, which amended Section 417CA and CB of the Companies Act.

Integrating the financial and non-financial

Increasingly, the trend is to integrate financial and non-financial information for the purpose of strategic planning and to provide investors and other stakeholders with a full picture of the firm. A growing number of entities are opting to use Integrated Reporting (<IR>) as an overarching structure for their reporting, recognizing that <IR> is more than the publication of an integrated report – it is an iterative process. If done properly, integrated reporting can strengthen governance and enable more informed decision making both internally (by management and the board) and externally (by investors and other stakeholders). However, if used as a mere box-ticking exercise, <IR> or other reporting frameworks can standardize disclosure at the expense of providing complete information on the entity's performance and prospects. Research from PRI,[3] the UN Global Compact,[4] Eurosif and ACCA[5] concluded that many investors do not believe reporting as it is currently conceptualized and performed sufficiently connects non-financial factors and business strategy and risk.

Opening keynote

Richard Howitt, CEO of the International Integrated Reporting Council opened the event by highlighting the difference between reporting, which is not an attractive subject, and information, which is not only attractive but also powerful. He identified three factors that are insufficiently addressed in current corporate reporting:

→ Overconcentration on short-term financial returns
→ Resources and relationships a company uses go far beyond financial considerations
→ Multiple audiences and demands for information across the company

Integrated reporting provides a solution to the above-mentioned dichotomy. At the most fundamental level, integrated reporting achieves this because it allows companies to link their reporting to their purpose.

Mr. Howitt pointed out that information for corporate reporting is typically produced only to be filed and not to be looked at ever again. Yet, corporate reporting exists for quite a different purpose: to establish information that should not be quickly forgotten. The annual report is the single most important statement, because it is what is communicated by the board and senior management. It is also still the most important mechanism for capital markets to obtain relevant information about the company.

The concept of integrated reporting harnesses demands for financial stability and long-term investment. The International Integrated Reporting Council (IIRC) enables businesses to forge this new type of reporting. The IIRC now works to proliferate the integrated reporting around the globe. In addition to Europe and the U.S., it has been pioneered by companies in Brazil and South Africa. Recently, Indian regulators called on the top 500 Indian companies to use it.

The IIRC is currently implementing two research projects to support this development. The first studies the benefits of integrated reporting. The second project explores the connection between the integrated reporting and delivering on UN Sustainable Development Goals.

Mr. Howitt noted that when he was the rapporteur for corporate responsibility in the European Parliament, it became clear that there was a need for new reporting mechanisms that would connect new requirements for environmental and social reporting with the existing reporting framework. Integrated reporting provides such a mechanism that allows companies to integrate financial and non-financial information required by law, including by the EU Non-Financial Reporting Directive, in a single coherent report, instead of producing separate statements. Italian company Unipol will be releasing an integrated report that is believed to be the first that explicitly aims to conform with the requirements of the Non-Financial Reporting Directive.

The integrated reporting concept also helps to address the problem that despite their proliferation, various sustainability frameworks, such as CDP or GRI have not been always fully integrated with the financial reporting of the company. Mr. Howitt concluded by saying that reporting is not an end in itself but rather a means to improve corporate behaviour.

Panel 1: Reporting and Corporate Governance

Background

The UK 2006 Companies Act requires directors to fulfill their duties by taking account of a broad group of stakeholders, as set out in section 172. The Strategic Report Regulations 2013 further state that the purpose of the strategic report is to set out how directors have fulfilled those duties. The recent BEIS Green Paper on Corporate Governance confirmed there is a requirement to report on how the board has discharged its obligations, although the method of fulfilling the requirement is not prescriptive. The FRC response to the Green Paper suggests there needs to be "a requirement to report more effectively".[6]

→ Given this context, the first panel focused on the following questions:
→ What is best practice for corporate reporting in relation to corporate purpose and the long-term success of the company?
→ How can corporate governance and reporting foster the appreciation and management of different capitals (i.e. integrated governance)?
→ What is the connection between directors' duties and reporting?
→ Is it possible to identify good reporting practices and models from the perspective of sustainable investors?

Discussion

Charlotte Villiers, Professor of Company Law and Corporate Governance at the University of Bristol, explained the recent rapid developments in the UK Companies Act. She identified several issues that have not been clearly resolved in the legislation, including in particular the definition of sustainability, (whether it concerns the company or the planet) and materiality. This partly explains why corporate reports often fail to provide the full story in a concise manner. Prof. Villiers pointed out that integrated reporting represents an opportunity to meaningfully reform reporting. With respect to regulation, Prof. Villiers mentioned that research shows that mandatory rules can promote ethical management, that there are certain elements of the corporate governance regulatory framework that should be reformed, and that the FRC could use its powers more strongly. She also identified the King IV Report on Corporate Governance in South Africa, which aims to promote inclusive capitalism, as a possible source of inspiration.

Yukako Kinoshita, Corporate Responsibility and EU Policy Research Manager at Hitachi's Corporate Office Europe, said that the number of Japanese companies preparing <IR> quadrupled in the last four years to reach 279 in 2016. Ms. Kinoshita highlighted key elements of Hitachi's experience implementing <IR>. The decision to start was based on the request of the Chairman. Hitachi decided to start by understanding its audience and key stakeholders. Integrated reporting replaced the annual report as a key communication tool with investors, but Hitachi continues to produce a sustainability report to provide detailed information requested by investors. As highlighted by one of the participants, Cosco provides an interesting comparison; Cosco publishes a statement on significant audiences and materiality alongside an integrated report and decided to no longer publish numerous reports. Finally, Hitachi - being a highly diversified conglomerate company - is doing <IR> for its main business segments, but it is still reflecting on how to report on the synergy between these business segments to provide a fully integrated report.

Ladislas Smia, Deputy Head of the Sustainable Investment Research department of Mirova, the Responsible Investment division of Natixis Asset Management, stressed that we need to distinguish between disclosure and performance and go beyond disclosure criteria. He considered that it is a waste of resources for companies to report on all available reporting frameworks instead of focusing on things that matter. The best practice in this respect is to have a concise report supplemented by side reports for those seeking additional detail. From the perspective of a sustainability-oriented investor, we should move away from distinguishing between sustainability for the company and for the society, and stop separating financial and ESG analysis.

ESG can be understood as a risk analysis, but that is only part of the story. The Sustainable Development Goals (SDGs) provide a good framework for understanding a company's strategy, a point supported by Ms. Kinoshita. The key information Mirova is looking for is different for each company. In addition to key risks and SDGs, Mirova also considers comprehensiveness and cohesiveness of the company's approach. Mr Smia also referred to the well-advanced French regulatory framework for reporting, including Article 173 of the Law on energy transition and green growth, which requires both institutional investors and listed companies to consider the implications of climate change on their business.

The panellists and participants from the floor then exchanged on several issues including materiality, role of regulation, big data, stakeholder engagement, and how to net the positive and negative impacts.

According to Ladislas Smia, qualitative assessment is based on materiality, but it is difficult to define it precisely. One participant mentioned the State Street Survey of 500 institutional investors, of which 92% opined that companies should identify material issues and 60% thought that the ultimate arbiter for materiality should be the board. The question of regulating materiality is a difficult one. On one hand, legal definitions can be easily gamed, on the other it is risky to have materiality as a filter. The French example of regulation in this area, which is not fully prescriptive but requires companies to consider and integrate issues such as climate change scenarios, shows an approach that seems to work well.

There was a discussion about to what extent Big Data and Artificial Intelligence will make corporate reporting useless. Some institutional investors believe they will find alpha in big data. The raw data, however, is not yet out there to replace analysts. Perhaps more importantly, as pointed by one of the participants with extensive experience in evaluating corporate reports, the annual report process brings together diverse corporate functions and gets them to articulate and define how they create value. In this way, the process creates the benefit of greater internal alignment and information sharing.

A quite separate question, however, is whether the current format for annual reporting is fit for purpose. Yukako Kinoshita concurred by explaining that <IR> has been useful for Hitachi's stakeholder relations as well as internal communication between departments. Ms. Kinoshita also saw great value in engaging employees in report preparations through consultations and review of key questions including those related to the materiality.

Panel 2: Reporting on Risks and (Net Positive) Impact

Background

The 2007/2008 financial crisis prompted fresh debate about the role of accounting and external financial reporting by financial institutions in helping detect or mask systemic risks and in exacerbating or mitigating such risks.[7] Nevertheless there is growing consensus that companies have a role to play in engaging with broad systemic risks, not least because the risks arising from the environmental and social areas, including but not limited to climate change[8] and inequality, may result in stranded assets, disruption to supply chains, and economic and political instability with significant impacts on the company.[9]

The panel focused on five questions:

- What is the way forward for the internalisation of externalities in accounting and reporting?
- How should companies report on systemic risks? How can risks and impacts be prioritised and explained to stakeholders?
- How can directors and executive managers be held accountable for risks and impacts?
- What are the implications for the design of disclosure obligations and accounting rules? How can a legislative framework best accommodate such best practice?
- What information on risks and impacts is necessary for quantitative analysis and can it integrate long-term value creation into its investment strategy?

Discussion

David Cooke, lawyer at ClientEarth, reflected on disclosure requirements with respect to systemic risks, and in particular climate change. In Mr. Cooke's view, disclosure requirements are clear on what needs to be reported but are less clear on the form. In this respect, the recommendations of the Financial Stability Board Task Force on Climate Related Financial Disclosures represents the best method of reporting on climate risk and as such may serve as an inspiration for policy development. The purpose of the strategic report is to inform how directors are performing their duties. For climate change and other systemic risks, the requirement is to report on how they affect the company in terms of material and specific risks to the company and how these are being managed or moderated. Current standard practice is to include a section in the strategic report together with a brief commentary. The question is whether that is particularly useful to investors.

Mr. Cooke was also asked to reflect on the role of the FRC. He suggested that FRC guidance on the strategic report is useful, but what is needed is oversight and enforcement. Problems that occur in practice, in particular in the case of fossil fuel companies, is that their consideration of climate-change related risks is based on bullish forecasts that are presented as the only possible or most likely scenario. The FRC has the power to apply to the court, but this has never been done. Another problem, which is currently being addressed, is that the FRC's investigations tend to be opaque.

Stephanie Hime, Founder and Managing Director at Little Blue Research, oversaw the development of the Natural Capital Protocol which, alongside the Social Capital Protocol and Human Capital protocol frameworks, has been designed to help clarify relationships between the company and stakeholders. Ms. Hime gave an example of a project from her practice which focused on engagement between utility service providers and vulnerable people. If the service was defined well, then a lot of risk for both people and providers was avoided. Ms. Hime stressed that a key challenge is to bridge the gap between reporting and actual decision-making and added that a lot of social and environmental impact is still unaccounted for. One possible strategy is to put a value on such impacts, but there needs to be clarity why there is a need to price human or environmental values and if doing so is a solution. Ms. Hime gave an example of a request to calculate the value of lives lost in work fatalities. Like for any other impact, it is technically possible, but it is probably not the right base tool for making decisions in such matters.

Omar Selim spoke about a macroeconomic trend that reallocates money from fixed income to equities. This trend has several implications. First, people will increasingly demand investors to align the investment strategy with their values. Second, this puts a burden on investors to process and analyse huge amounts of data. Reflecting this, Arabesque has developed S-Ray - a meta-analysis tool using the results of over 200 ESG benchmarks. The S-Ray is applied only to companies that adhere to the UN Global Compact. Furthermore, companies that violate key environmental, social, human rights and anti-corruption standards are removed from the portfolio.

As Mr. Selim put it, there is a beauty in studying big patterns because although it is not yet clear what is the connectivity between the data (i.e. where the causality lies), the results of the meta-analysis anticipate risks of poor performance connected to ESG problems and scandals. The research is clear as regards the correlation between capital market and sustainability performance: He stated that sustainability is to finance what electricity is to cars and then concluded that S-ray is what battery technology is to the electric car industry "

Closing remarks

Filip Gregor, Head of Responsible Companies Section at Frank Bold, concluded the event by presenting the conclusions of the collaboration between the Purpose of the Corporation Project and the Modern Corporation Project and outlining the next steps.

Between 2014 and 2016, the two initiatives organised the Corporate Governance for a Changing World Roundtable Series to identify the outcomes that corporate governance should deliver and working back from there, design corporate governance which is fit for the challenges of the 21st century. The series brought together more than 260 leaders in business management, investment, regulation and academic and civil society communities. The key finding of this process was that although there may be many variations to optimal model of corporate governance, any functional model must place corporation in the centre, rather than on an orbit of its stakeholders (most typically shareholders) interests.

The conclusions from the series addressed matters concerning clarification and protection of corporate purpose through governance, clarification of directors' and institutional investors' duties, the role of boards, incentive structures, stakeholder engagement, company-investor relationships, and corporate reporting. The full report is available at: www.purposeofcorporation.org/corporate-governance-for-a-changing-world_report.pdf

Mr. Gregor highlighted that corporate reporting plays a central role in corporate governance because it connects director duties, stakeholder relations, and integrated governance. Integrated reporting emerges as the essential tool in this respect. It allows companies to formulate and protect a corporate-centric strategy that focuses on their longevity and builds on symbiotic relationship with society. It also provides pathways for companies to build trust and reliable shareholder base.

The Purpose of the Corporation Project and Modern Corporation Project will organise a research consortium that will facilitate collaboration between researchers and companies that are implementing integrated corporate governance principles. The aim of the consortium will be to develop research to help companies overcome the obstacles they are facing in practice and present the findings of this work to broader audience to help to proliferate good practice and contribute to sound policy development.

Organisers

This event was the last in a series of three on corporate governance held at Cass Business School in 2017 aimed at charting the development of practice and policy towards a governance model fit for the challenges of the 21st century. Summaries of previous events are available here and here.

The Cass events have been jointly hosted by Cass Business School and Frank Bold, with support from Ecole des Mines and Hertfordshire Law School. Dr. Jeroen Veldman and Prof. Hugh Willmott run the Modern Corporation Project at Cass Business School and provide the academic basis for the Purpose of the Corporation Project, an open-source platform led by Frank Bold, a European purpose-driven law firm. The Project brings together leading experts and organisations interested in promoting the long-term health and sustainability of publicly listed corporations in the areas of policy-making and business management.

Between 2014 and 2016, Cass Business School and Frank Bold hosted a global series of roundtables on corporate governance with events held in Brussels, Breukelen (The Netherlands), London, New York, Oslo, Paris and Zurich. The results of the series of events are compiled in the Corporate Governance for a Changing World report.

[1] Villiers, Charlotte and Mähönen, Jukka, Article 11: Integrated Reporting or Non-Financial Reporting? (December 8, 2014). The Greening of European Business under EU Law: Taking Article 11 TFEU Seriously, Beate Sjåfjell and Anja Wiesbrock (eds), Routledge, (2015) ; University of Oslo Faculty of Law Research Paper No. 2014-42. Available at SSRN: https://ssrn.com/abstract=2535279

[2] For further information about the EU Non-Financial Reporting Directive and other legislative developments, see Frank Bold, Compliance and reporting under the EU Non Financial Reporting Directive, available at http://en.frankbold.org/news/compliance-and-reporting-under-eu-non-financial-reporting-directive .

[3] See PRI response to UK Government: Non-Financial Reporting Consultation.

[4] UN Global Compact, PRI and Accenture (2014): The Investor Study: Insights from PRI Signatories.

[5] Eurosif and ACCA (2013): What do investors want from non-financial reporting? 92% of investors agreed or strongly agreed that financial and non-financial information should be more integrated.

[6] The FRC's position is that the Strategic Report Regulations 2013 should be amended to link the s172 duty and reporting under s414C.

[7] Harris, T. S., Herz, R. H., & Nissim, D. (2012). Accounting's Role in the Reporting, Creation, and Avoidance of Systemic Risk in Financial Institutions.

[8] Johan Rockström et al., 'Planetary boundaries: exploring the safe operating space for humanity', Ecology and Society, 14(2) (2009), available at ecologyandsociety.org/vol14/iss2/art32/. The economist Raworth has put forward the concept of the 'doughnut' as a conceptual model for understanding the 'ecologically safe and socially just space' within which we need to operate to respect the planet's resources. Kate Raworth, 'Doughnut Economics: Seven Ways to Think Like a 21st Century Economist', Chelsea Green, 2016, and Melissa Leach, Kate Raworth and Johan Rockström, 'Between social and planetary boundaries: Navigating pathways in the safe and just pathway for humanity

[9] Sullivan, Rory, Will Martindale, Elodie Feller, and Anna Bordon. 2015. "Fiduciary Duty in the 21st Century." Global Compact Report, United Nations, September 9.