New Wine, New Bottles: The Rise of Non-Financial Reporting

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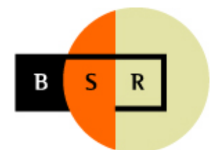
A quiet renaissance in corporate reporting is gradually transforming its purpose, content and readership. This transformation predates the recent spate of accountability failures in cases such as Enron, WorldCom and Tyco in the U.S., and Ahold, Parmalat and ABB in Europe. But it is accelerating because of them. In a few short years, a new generation of non-financial reporting will have moved from the extraordinary to the exceptional to the expected, and in the process will establish a new standard of transparency unimaginable even a decade ago. For forward-looking companies, opportunities abound to stake out leadership positions among investors, customers, communities, activists and other stakeholders, while reaping the benefits associated with trust and integrity in global markets.

For a glimpse of next-generation reporting, browse the 2004 Annual Report of Novo Nordisk, the Danish pharmaceutical firm.[1] The document begins with sections on "Defeating Diabetes" and "Innovation," the latter focusing on R&D and the product pipeline. The next section is titled "Competitive Business Results," which covers corporate strategy and performance highlights. Within that section is – and here's the real frontier – a 60+ page section titled "Financial & Non-Financial Performance Data." Included are standard financial accounts of the company juxtaposed with non-financial data such as Current Risk Profile, Competition and Business Ethics, and People. Within this section, too, is the Global Reporting Initiative (GRI) content index, signifying where GRI indicators are available either within the Annual Report or on the company website. Following the performance section, the report concludes with sections on the "Challenging Workplace" and "Values in Action," including a discussion of "An Industry Under Fire."

If this type of integrated, balanced and candid reporting were unique, it could readily be dismissed as the work of a company widely known for being among the most sophisticated globally in matters of corporate responsibility. But such is not the case. Two years earlier, another global pharmaceutical firm, Novartis, published *Caring and Curing*, another example of a report that blends the financial and non-financial. Indeed, over half the 160-page report was devoted to non-traditional, non-financial information. In the same vein and time period, GKN, a $5.5 billion UK-based global automotive and aerospace engineering company, integrated its "Social Responsibility Review" into its 2002 annual financial report. BC Hydro, the $4 billion Canadian electric utility, published its *2003 Annual Report: Reporting on the Triple Bottom Line Performance*, presenting its financial performance within an array of social and environmental performance information. DSM, the Dutch chemicals and life sciences firm, and Natura, the Brazilian cosmetics company, do the same. SAS Group, the Scandinavian airline, produced its 2004 *Annual Report & Sustainability Report* using an integrated format, as did BASF, the German chemical firm, in its 2004 *Shaping the Future* report.



[1] http://www.novonordisk.com/annual-report

While integrated reporting is embryonic, non-financial reporting is approaching pre-adolescence. At least 2,000 companies worldwide are publishing stand-alone citizenship, sustainability, environmental and social reports. Some 650, including all those firms referenced above, use the framework of the GRI, the emerging international standard for non-financial disclosure. The quality, rigor and completeness of reporting has undergone dramatic enhancement relative to just five years ago. Who would have predicted that an apparel firm like Nike would disclose a complete list of its 750+ contract factories in its *2004 Corporate Responsibility Report,* or that BP would dedicate sections to payments of fees and royalties to host governments and HIV/AIDS in its 2004 sustainability report, *Making the Right Choices*. It is a fast-moving, dynamic movement that looks far more like a race-to-the-top than a race-to-the-bottom. The former days of public relations and thinly veiled product and service promotion posing as serious reports are quickly coming to a close. By all indications, non-financial reporting is on a trajectory to becoming standard business practice in the early 21st century.

Drivers

Reporting and its parents – transparency and accountability – are signature issues of the post-Enron area. Fueled by unrelenting news of accountability and governance malfeasance, the march toward higher reporting standards is irreversible. While the misconduct of a few companies has fueled the trend, however, its roots are broader and deeper than the post-2000 scandals.

Since the birth of the modern joint stock corporation some 200 years ago, companies morphed from cozy, limited partnerships into entities of increasing scale, complexity and passive investor ownership. The first 125 years of this evolution witnessed a steady expansion of corporate rights – rights to merge and acquire, rights to limited liability, rights to due process. Far less evolution occurred on the side of obligations. While exceptions such as early anti-trust legislation are important markers, unfettered markets and minimal regulation dominated the period through the 1920s.

The result: an accountability deficit in which all company stakeholders – investors and non-investors – were essentially excluded from the knowledge, oversight and control associated with rapid industrialization. What Roger Cowe calls the “tennis club” model of corporate governance – small, partnership organizations comprising individuals connected to, and knowledgeable about, the entity they own – is clearly incapable of delivering real accountability within organizations that operate at a scale and complexity characteristic of the emerging modern joint stock company.[2]

The economic collapse of the 1930s abruptly brought an end to unbridled business and markets in both the U.S. and Europe. Though basic accounting principles were centuries old, standard accounts were essentially unknown, and accountability as a broader obligation of business to society was yet to be born. Nonetheless, the 1930s-1940s saw the first securities regulations, the birth of standardized financial accounting, and the arrival of public financial reporting. It was a bold beginning and process that even today remains a work in progress as new issues – stock options, pensions, derivatives – continue to challenge the financial standards community with changing concepts of corporate value and performance.

The Debut of Non-Financial Reporting

More than a half century after the birth of modern financial reporting, it is becoming increasingly clear that incremental changes in corporate reporting – the work of national and international financial accounting boards – is insufficient to correct the systemic weaknesses that persist. For companies failing to grasp the reporting transformation, disquiet among corporate stakeholders over time will intensify with each cycle of annual reports whose contents seem increasingly detached from the realities of 21st century sources of value, risks and opportunities.

For investors, current reporting simply does not deliver information on the intangible assets that today account for well over half the market’s capitalization. Quality of management, brands and reputation,

[2] Roger Cowe, *Stakes Not Shares: Curbing the Power of Corporations*. London: New Economics Foundation, 2001.

knowledge systems, governance, social and environmental risks and opportunities – the whole gamut of intangibles has yet to appear in a consistent and reliable fashion in company reports.[3] While the U.S. Financial Accounting Standards Board and the International Accounting Standards Board sporadically have undertaken efforts to correct this deficiency, little progress has been achieved. Addressing such issues as stock options, pension funds and derivatives accounting rules has trumped attention to non-financials and intangibles, despite their rapid dramatic ascent as dominant value drivers.

For other stakeholders – consumers, employees, suppliers and activists – the accountability deficit is equally – perhaps even more – troubling. The pioneering companies that are leading the non-reporting wave understand what the majority do not: the utility of conventional financial reporting is increasingly disconnected from what stakeholders need and expect to make informed decisions.

The Cost of Opacity

The cost of deficient disclosure is greater than most companies realize. Evidence of these 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, higher price-to-book ratios and the ability to lower the cost of capital.[4] In a similar vein, an assessment of 300+ GRI reporting companies by the London consultancy Linstock indicates moderately positive correlation with lower share price volatility, higher operating profits and revenue growth.[5]

Meanwhile, various studies by consultancies and rating groups find investors' willingness to pay for strong governance practices and above-average performance of portfolios containing well-governed companies. Further, leading rating groups such as S&P and Fitch, as well as specialized organizations such as GovernanceMetrics, are developing governance quality rating schemes to address the market's appetite for more disclosure of this key non-financial indicator.

No one of these studies or initiatives yields conclusive evidence of the cost of opacity or even the causal relationships between transparency and financial performance. But, taken together, the weight of evidence decidedly points to 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 reporting.

A Process, Not an Event

For companies large and small, public and private, especially those that participate in global markets, it is not a question of "if" they should respond to these trends, but rather "how" and "when." Non-financial reporting is here to stay, even while its form and rate of uptake remain fluid. If there is an element of choice, it is only between what Don Tapscott and David Ticoll, in *The Naked Corporation,* call "active transparency" that is shaped to support strategy, versus "forced transparency" in which the firm's transparency strategy is largely reactive and crisis-driven.[6]

For leadership companies, the choice is obvious. But shedding old habits requires vision and persistence, as well as strong backbone when legal staff raises questions about the risks of disclosure. In today's business climate, the risk of non-disclosure equals – or more likely exceeds – the risks of high standards of disclosure.

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[3] Baruch Lev, *Intangibles: Management, Measurement and Reporting*, Washington D.C. Brookings Institute, 2001; Jonathan Low and Pam Cohen Kalafut, *Invisible Advantage: How Intangibles are Driving Business Performance*. Perseus Publishing, 2002.
[4] Sandeep Patel et al "Transparency and Disclosure: Overview of Methodology and Study Results-United States," Standard & Poor's, 2002. http://www.gtnews.com/article/5287.pdf.
[5] Linstock Consultants and Imagination, *Added Values? Measuring the "value relevance" of* sustainability reporting, London, February 2004. Section 1: Case studies & discussion.
[6] Don Taspscott and David Ticoll, *The Naked Corporation.* New York: Free Press, 2003.

With the benefit of more than five years of experimentation and learning led by more than 600 GRI reporters and scores of others worldwide, six core elements of an integrated reporting approach are now discernible:

Leadership CEOs, with board understanding and support, need to take a stand. Excellence in reporting is an antidote to the loss of confidence in corporations documented in virtually every opinion poll in the last few years. A durable commitment to leading edge reporting is a key tool to restoring public trust. In the U.S. and elsewhere, CEOs are now – and many observers would argue belatedly – held accountable for financial statements. Already GRI's "in accordance" reporting requires such accountability for non-financial reporting. CEOs and boards that proactively step up to this challenge can anticipate recognition and rewards in the coming years.

Benchmarking Companies in every sector – extractive, manufacturing and services – and virtually every industry are now practicing non-financial reporting. Various web-based data sets such as GRI's (www.globalreporting.org) enable identification of best practices. For newcomers to reporting, the best benchmarks are those companies in the same sector with a few years of reporting behind them. Blending this experience with the unique messages of the newcomer is the recipe for both efficiency and excellence.

Execution Getting started and continuously improving reporting require cross-functional involvement. In its best form, non-financial reporting entails both shared responsibility and shared benefits. R&D, production, marketing, financial, environment, health and safety, human resources, community affairs and other functions all have much to contribute and much to gain. Indeed, many companies report that cross-functional collaboration and learning is one of the single greatest rewards of non-financial reporting. In its best form, it triggers conversations that otherwise would not occur, insights that would not otherwise surface, and innovations that would not otherwise materialize.

Engagement Non-financial reporting requires engagement with non-financial stakeholders. Effective 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 worst. A pharmaceutical company report that omits drug access, an energy company that omits climate change, or an apparel company that omits contract shops will fail the test of credibility while squandering resources allocated to its reporting activities.

Monitoring Integrated reporting is a fluid, fast-moving work in progress. New norms and measurement methods appear on a regular basis. The Organisation for Economic Co-operation and Development'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 every firm doing business in global markets. Draft revisions to UK Company Law in the form of an Operating and Financial Review (OFR), the 2004 Canadian Provincial and Territorial Securities Acts, U.S. Securities and Exchange Commission environmental disclosure rules, and many others across the North and South are reshaping the reporting landscape. These and other initiatives represent an emerging body of practice that is gradually laying the foundation for the next generation of generally accepted disclosure practices. They are as important for trend spotting as for their detailed requirements.

Assurance An elaborate infrastructure of professional standards and protocols applies to financial reporting. Auditing standards are increasingly stringent in the wake of the Enron-era scandals that exposed the flaws in methods and practices, as well as ethical breakdowns on the parts of both internal and external auditors. Assurance of non-financial reports is evolving, thanks in significant measure to the path-breaking work of the AA1000S assurance framework. There can be little doubt that assurance is coming to non-financial reporting. Indeed, why should reporters expect a lower standard of assurance than that applied to financial reporting? The task for both the experienced reporter and the newcomer is to track assurance trends and to position its management systems for the day when assurance – by voluntary or mandatory action – becomes part of the company's reporting process.

Seeing the Future
The reporting renaissance is irreversible. It is integral to doing business and retaining the license to operate in the coming decades. If wisely managed, it is also an opportunity to sharpen management's effectiveness while helping to position the firm in the vanguard of firms committed to corporate responsibility. Companies that await the conclusive business case for non-financial reporting are missing the opportunity to strengthen what ultimately is every firm's most valuable asset: trust – in its management, products and services. For laggards, stakeholder patience will wear thin, sooner or later. For leaders, the future holds rich rewards.

Still in its pre-adolescence, it remains a work in progress characterized by experimentation and learning. Its emergence as a practice among hundreds of companies worldwide in less than a decade is, in a historical context, a development whose rapidity has few peers.

One scenario of the future sees steady progress among multinational companies, with gradual penetration into the small- and medium-size enterprises, especially those that service multinational supply chains. It is a scenario dominated by voluntary reporting, minimal governmental mandates, and consistent though only partially effective pressures from non-governmental players such as stock exchanges and shareholder activism that begins to tilt reporting from "soft" to "hard" voluntarism.

An alternative scenario begins like the first, but is jolted by unexpected events that propel government to take strong corrective action in the face of serious disclosure breakdowns akin to the Enron-era Sarbanes–Oxley legislation in the U.S. This future witnesses sudden revelations about previously unknown and widespread human rights or labor standards violations, or perhaps corrupt practices in relation to royalties to governments, across multiple companies or sectors. This, in turn, triggers governmental action in several leading countries. Laws are enacted whereby government agencies mandate reporting and establish their own standards or alternately delegate to GRI the responsibility to steward non-financial reporting standards (analogous to how the U.S. delegates financial reporting to the Federal Accounting Standards Board).

Regardless of whether the first or second, or a hybrid, scenario emerges, a number of parallel developments seem inevitable. ***Integration of financial and non-financial*** disclosure will accelerate, exemplified by the few leading firms (illustrated by the examples at the beginning of this article) that already see the logic and efficiency of such practice. At the same time, ***metrics will continue to evolve***, with environmental, social and economic indicators moving steadily toward a set of generally accepted standards applicable to all companies. Concurrently, ***sectoral initiatives*** that build on core metrics will be key instruments for ensuring that disclosed information is in fact material information to stakeholders. Finally, the ***use of technology*** to communicate and access information will experience a quantum leap as companies deploy the full range of media and mechanisms to disseminate their non-financial performance information. In a matter of a few years, ***indices and ratings of non-financial performance*** will become as commonplace as financial performance indices and ratings are today.

In the end, leading non-financial reports share one overarching attribute – *they provide the reader with a penetrating look into the mind of the company* – its self-concept, the way it makes decisions, and how such decisions are linked to outcomes disclosed in the report. Leading reporters are astute at using data to portray, in a fair and balanced fashion, past achievements, current shortcomings, and future opportunities and challenges in a credible fashion. It is these reporters that will be at the vanguard of elevating non-financial reporting to the level of a standard business practice worldwide in the coming decades.

Non-financial reporting will succeed not because of specific indicators, measurement techniques, formatting or communications strategies. Instead, it will succeed because it offers stakeholders what financial reporting alone fails to offer: a window on the character and competency of the reporting company.

About the Author

Dr. White is a Vice President of Tellus Institute where he directs the Corporate Redesign Program. He has 30 years of experience in the area of corporate social responsibility, advising multilaterals, foundations, corporations, and NGOs on strategies and policies for corporate responsibility, pollution prevention, performance indicators, extended product responsibility, and integrating environment into business strategy. He co-founded the Global Reporting Initiative and served as its Director from 1999-2002. He recently co-founded Corporation 2020, an initiative focused on designing future corporations to sustain social purpose. He is currently serving as a BSR Senior Advisor working with our network of leadership companies and other CSR stakeholders to achieve success in ways that respect ethical values, people, communities and the environment.