Sustainability as a Social Movement

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I like to think of myself as a capital market activist, and that's where you get the title of my most recent book—*The Integrated Reporting Movement*. I think of this as a social movement. The only country where integrated reporting is mandated, thanks to the leadership of Mervyn King, is South Africa. What he did in South Africa is interesting, because it was reporting in a governance context. You can think about this talk as corporate reporting meets corporate governance.

I'm going to do five things in this talk. I'm going to give you some context. I'm going to talk about integrated reporting. Then I'm going to talk about materiality, and I'm going to talk about fiduciary duty. Then I'm going to talk about a statement campaign, and I'm going to give you some data.

If you think about sustainable development—the classic definition from the Brundtland Commission is meeting the needs of the current generation without sacrificing the needs of future generations—the private sector has a fundamental role to play. What I'm attempting to do is to mobilize market forces: companies, investors, and the intermediaries, accounting firms, banks, and lawyers.

There are tools that can foster sustainable development within the corporate community and the investment community. Integrated reporting is one of those tools, but I have become convinced over the past couple of years that until we can get to boards of directors, and until we really understand this question of fiduciary duty on both the corporate side and on the investor side, we're not going to make the progress that we need to in terms of reporting.

Increasing Interest in Sustainability

About four years ago, I gave a talk at a client conference for RobecoSAM, an asset manager in Zurich. Michael Baldinger, the CEO, stands up and says, “The corporate community is a decade ahead of the investment community when it comes to sustainability; CEOs are starting to think about these things more in terms of how they manage their companies.” I thought it was a pretty bold thing for him to say in front of a bunch of his clients. For a long time, that was largely true. I still think there is a lot of “greenwashing” in the investment community. But what I have seen over the past 12 to 24 months is this dramatic increase in interest in sustainability in the investment community.

The Portfolio Decarbonization Coalition was started by Mats Andersson with a goal of getting pledges from investors to decarbonize their portfolios. Their initial goal was $1 billion. By the time COP 21 came last December, they had $600 billion in assets under management committed to this program. Big pension funds like CalSTRS & CalPERS have integrated ESG [environmental, social, and guidance] issues into their decision making across all of their asset classes. The big banks have platforms where they're selling to individuals, increasing demand for “green product.” You have this enormous transfer of wealth, $29 trillion in the 211,000 wealthiest families in the world, that is increasingly looking at these issues. Now you're starting to see the investment community become increasingly interested in sustainability, and you've got boutique firms and investment banks starting up. I think this growing interest, rather dramatically and suddenly, is an important development.

You see a lot of statistics on both the investor side and the corporate side where there is increasing interest in sustainability. I'm going to give you a highlevel sketch of what I think the relationship is between integrated reporting and sustainability reporting.

It's remarkable what Bob Massie and Allen White did, with the leadership of Mervyn. There's been exponential growth in the number of companies that are producing reports based on GRI. For the most part, that's almost all voluntary, including in the United States. Wherever you've got regulation around ESG issues, that's really important. A couple of years ago, the EU passed an accounting directive for non-financial information. Every EU company with 500 people or more, public or private, is going to have to start producing a sustainability report or provide non-financial information on an annual basis. The member states are figuring out how they're going to implement that.

One of the things that comes up when you start talking about this other information is, “What does it mean?” My smart-ass answer is, “It's pretty simple: What if companies said, ‘Our revenues are pretty good this year,’ and there was no number? Well, that's what they do with human capital.” But until the SEC was formed in the United States, there were no accounting standards and no reporting requirements, and a lot of companies didn't report their revenues, even if they were listed companies. This issue of standards, this infrastructure, is incredibly important.

Integrated Reporting

We've talked about integrated reporting. It's interesting that, in a 40-page document produced by the IIRC [International Integrated Reporting Council], the word “sustainability” is only used three times. What you see is an evolution from smooshing together sustainability information and financial information to thinking about the information that's critical to create value over the short, medium, and long term. This gets into the distinction between sustainability and integrated reporting.

We've talked a lot about the “six capitals.” Companies have impacts on all of these six capitals. That's something that's not accounted for in terms of financial accounting. There are externalities created: They can be positive, like creating jobs, and they can be negative, like carbon emissions and water pollution. What integrated thinking is about is being conscious of the impacts that you're having on these capitals. There are some guiding principles. There are some content elements. It's not a doctrine or guidance. Your integrated report doesn't have to look like the example.

Barry [Melancon] was talking about how the United States has been slow in terms of picking up integrated reporting. You get a lot of excuses: “It's hard to get this information. We're going to be sued. We're already doing all this reporting.” But you know what? If you map the guidance for the Form 10-K to the content elements of the international IR framework, they're basically the same. The language is different, but if a company is filing a decent 10-K and adding some narrative information, morphing a 10-K into the annual report, then morphing an annual report into an integrated report really isn't that hard.

The genius of what Jean [Rogers, coauthor of *From Transparency to Performance*] did was to come from a 10-K point of view, and note that Regulation S-K just says, “If it's material, it goes in the 10-K.” So SASB is not looking for more regulation—it's just attempting to provide some guidance. And for each of these industries, SASB starts with a fairly long list, but because the audience is targeted to investors, it's a relatively small list, about seven or eight things. This complaint about this burden on companies just doesn't make any sense, because when you look at what the material issues are, they make intuitive sense. If you're not paying attention to this as management, if you're not getting this information as the board, you're not managing the company well. The incremental cost of reporting this stuff is not all that great.

Barry talked about GE's first integrated report. They've combined their financial report, their proxy statement, their sustainability website, and it's only 68 pages. Twenty-five of those pages are basically the letter from [CEO] Jeff Immelt. And it's a very informative letter. I have compared the GE integrated report to the international IR framework, and it does a really good job. It ticks a lot of the boxes that you would expect; it's tremendously transparent around corporate governance and compensation. The one area that I would fault it is that it doesn't say anything about materiality.

I propose that the board issue an annual statement of significant audiences and materiality—because what's material will be a function of the audience.

Materiality

Materiality is a fundamental concept in reporting, financial reporting, sustainability reporting, and integrated reporting. Here is what the SEC says: “A piece of information is material if in the total mix of information it would influence a reasonable investor's decision.” That's it. It's a little Zen-like. What was the first piece of information? What is a reasonable investor? When you cut through it all, the materiality determination process is entity-specific. It's binary, and it's based on judgment. I would argue that judgment ultimately needs to come from the board of directors.

In my book, I propose that the board issue an annual statement of significant audiences and materiality—because what's material will be a function of the audience. If the only audience you care about is short-term shareholders, then a lot of this ESG stuff is not going to be material.

There's three things I like about this one-page statement of significant audiences: First of all, it's my idea. Secondly, it's only one page. It's not a whole integrated report; it's not going to be expensive. Third, it's values-neutral. You don't have to care about sustainability. If you don't, just tell us that's how you're making your resource allocation decisions.

Fiduciary Duty

When I started talking to people, they said, “The lawyers will never let you do it.” Why? “Because directors have a fiduciary duty to put shareholders first, so forget about all this other audience stuff.”

Some of us have tried to address this urban myth of shareholder primacy. The gospel on this for the United States is the work of Lynn Stout, who wrote *The Shareholder Value Myth*. It's a very detailed, sophisticated analysis of what is basically an ideology. With the support of the American Bar Association and the UN Global Compact, and my friend Mervyn, I now have legal memos on fiduciary duty for every G-20 country and another dozen or so. These are all in the public domain. They're on the websites of the American Bar Association and the UN Global Compact. I think they're an enormous resource. This is the first pillar of my statement campaign. The purpose of these legal memos is to clarify fiduciary duty.

When you look at all these legal memos, it's interesting because Sweden is more like the United States where it says, fiduciary duty is owed to the corporation. In other jurisdictions like Brazil, it's more explicit that the board has an obligation to take account of other stakeholders. There is no jurisdiction where it says the board *cannot* take account of other stakeholders, and then the obvious question is which stakeholders. If you look at these duties—duty of faith, loyalty, and care—a director that's representing the interests of the corporation as a legal entity over the long term, in their judgment, if they think that there are other audiences, that there are stakeholders that are significant, the law permits them to take this into account.

There is a similar issue on the investor side. Principles for Responsible Investment came out last fall with an interesting document called *Fiduciary Duty in the 21st Century* that asked, “If you take ‘sustainability’ into account, are you violating your duty as a trustee of a pension fund?” And the report said, “You're actually violating your fiduciary duty if you don't.” In November, the Department of Labor issued an interpretive release on ERISA [Employee Retirement Income Security Act of 1974] which basically said, “Yes, fiduciaries of pension funds, if in your judgment long-term returns will be affected by these issues, it is perfectly okay to take this into account.”

This issue of governance, of having boards of directors take responsibility for this, of having fiduciaries on the investor side take responsibility, is key. Because on the company side, the board is really the backstop for management. They determine compensation, they determine time frames. When you have short-term–oriented activist investors coming in just looking to make a quick buck, if the board doesn't stand up and support management, what do you think is going to happen?

The Statement of Significant Audiences and Materiality

Getting organizations or people to go first is one of the hardest things in the world. Everybody wants to be a leader, but nobody wants to go first. I have written to companies that I know are doing integrated reporting and said, “I've got a great opportunity for you. You could be the first company to publish a statement of significant audiences and materiality.” And they write back, “Thank you so much for thinking of us. Who else is doing this?”

I met with this Swedish company called Atlas Copco, an industry products company, about a year ago. They've been doing integrated reporting for a couple of years. It's interesting the language here that they use: “This is our strategy for sustainable, profitable growth.” They're not saying, “This is our sustainability strategy.” I distinguish between sustainable strategies, which is what integrated reporting is about, and sustainability strategies or CSR [corporate social responsibility] programs, which are perfectly well intentioned but tend to be sideshows. What you have inside companies is this détente between the CSR people and the CEO and especially the CFO. The CSR people don't have a lot of resources and they're pretty low on the food chain, and the CEO doesn't trash sustainability and they don't rock the boat. It's a sideshow until we think about sustainable strategies: those really significant issues that affect the ability of the company to create value over the short, medium, and long term, and become part of the conversation with investors and with analysts.

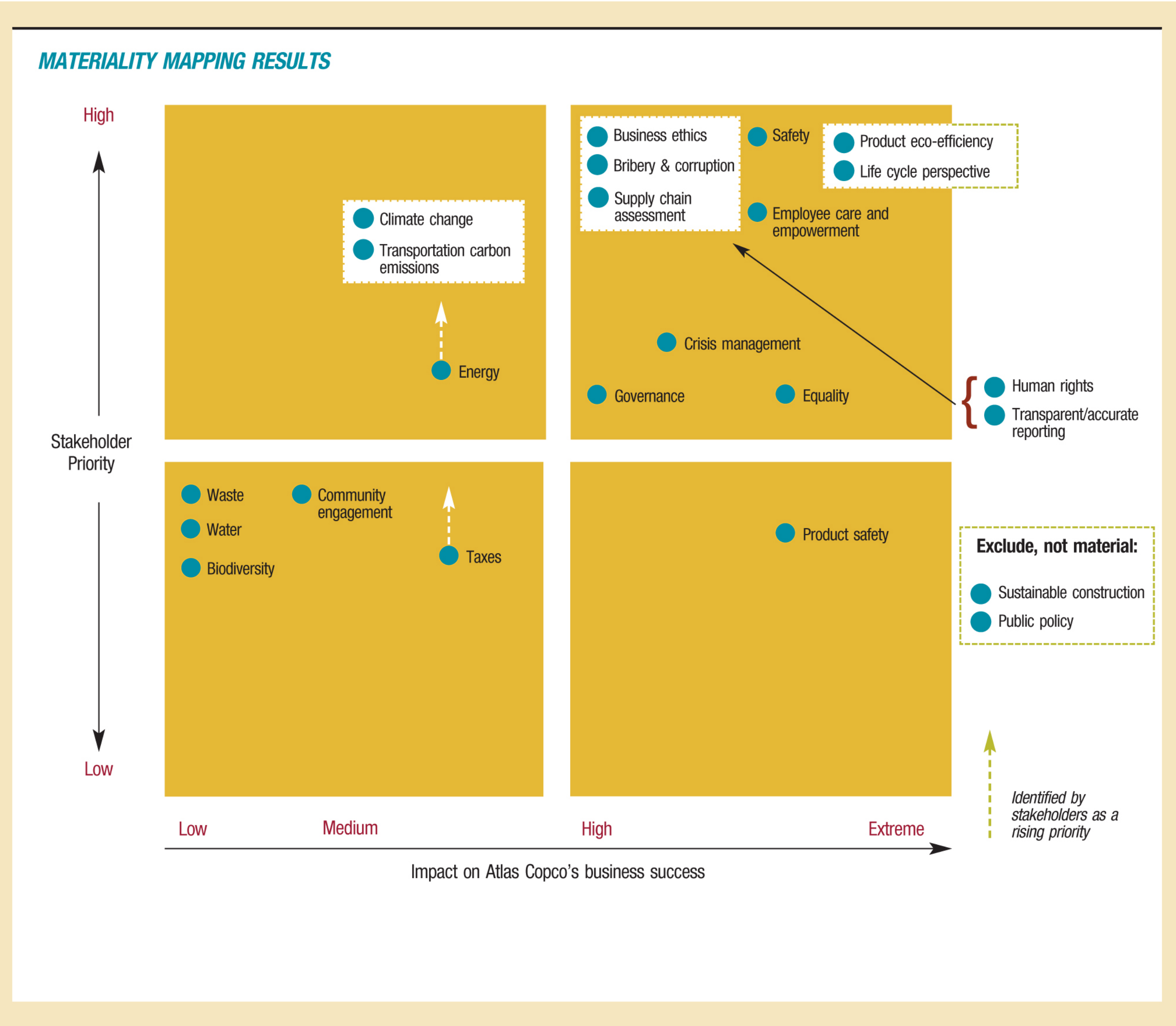
Out of the blue, I got an e-mail from Mala Chakraborti at Atlas Copco that they have published the first statement of significant audiences and materiality. That's good news. And now the mission is to try to build on this momentum. The campaign has these pillars, which are these memos on fiduciary duty that clarify you're not going to go to jail if you do this. You need some companies to do it, and then you need investors to start asking for it.

What Atlas Copco also produces is a materiality map [see the *Exhibit*]. The company can and does have an obligation to form a point of view about what other stakeholders think is important. What you've got as the X axis is materiality to the company, and the Y axis is the company's perception of importance to stakeholders.

Atlas Copco went through a very sophisticated engagement process, which is key. One of the major distinctions between today and the financial

EXHIBIT

Atlas Copco Materiality Map



reporting of the '50s and '60s is the much higher levels of genuine engagement on the part of corporations. They're basically saying that "business ethics, bribery, safety—they're material to us and we recognize they're important to society. Productivity is important to us, but society is not too worried about it. There are some things that really are not material to us as a company, given our sector, like climate change. We recognize society cares about it, and so we have an obligation to report on it. And then there are some things down here in the bottom left-hand box that aren't material to us and we don't think society cares all that much."

Now this is tremendously important because this is showing the ability to exercise judgment and not greenwash and say, "We care about sustainability and we're going to create value by taking care of all of our stakeholders." No, you've got limited resources. You have to choose, and so why don't you just be transparent about that?

People ask, "Is integrated reporting going to make sustainability reporting go away?" and my answer is "No." The integrated report is for investors and other significant audiences as determined by the board. That then is the basis of materiality. Everything on the right of this materiality map goes into the integrated report. This is sustainability reporting, where a company has an obligation. The stuff that's in the bottom left-hand corner, you probably shouldn't even be reporting on it, because it's just noise.

People say, "If I do this, and I say that these issues and the stakeholders aren't material to me as a company, they're going to be upset." Well, that's right. There will be groups trying to shift those issues across that line. It's their right. But at least there is the basis of an honest conversation.

Investors say, "We'd like to care about sustainability, but we're not going to wade through a hundred-page sustainability report with pictures of blue skies and children with flowers. We want to know what information is material from a sustainability point of view." That's why I think SASB [the Sustainability Accounting Standards Board] is important. Tell us how it relates to financial performance. Does it affect revenues? Does it affect costs? Does it affect cost of capital? All of this is doable. There is an agricultural chemical company called Yara that produced the first named sustainable value matrix about a month ago in their report. You can see judgment was exercised. What they do, and it's hard to find, is provide a very fulsome description of the materiality determination process. Having a company publish a materiality matrix is kind of interesting. But what you really want to know is the methodology that they use.

Looking at the Data

The biggest problem is the finance faculty—they're the last to change. When it comes to integrated reporting, the biggest pushback is from CFOs. The CEOs get it; CFOs are a problem. Some of it is language. If you go to a CFO and you say, "I'd like to talk about sustainability," their eyes glaze over. But if you say, "I'd like to talk about the material issues that you think your shareholders would care about," then maybe you can have a conversation. What my colleague George Serafeim did was identify the limited number of material issues—environmental, social, governance—for each of the industries SASB had published guidance on. Then he was able to get performance metrics and then created portfolios of firms.

Companies that were performing well on the material issues for their sector, their financial performance was better than those that were performing poorly on the material issues for their sector. It kind of makes sense—they're investing their resources in the things that matter for that particular sector. The most interesting finding is that the companies that had the best financial performance were performing well on the material issues and performing poorly on immaterial issues—which means that judgment was exercised at the management level, at the board level, to say, "We can't do everything." Every corporation, no matter how big, has got limited resources.

Reaching the Capital Markets

We need frameworks like the IIRC. We need standards like GRI [Global Reporting Initiative] and SASB. But the private sector has a fundamental role to play in creating a sustainable society. Here's some context: The largest company in the world has sales that are larger than the GDP of 164 countries. If you looked at the aggregate revenues of the largest thousand companies of the world 30 years ago, they were 30% of the GDP of the OECD [Organisation for Economic Co-operation and Development] countries. Today, they're 75%.

Large companies have more resources than most countries, so their economic impact is huge. The market cap of Intel is as big as the market cap of all of Mexico. Visa has the same market cap as Brazil.

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The United States is the critical market to crack. It's got the biggest companies. It's got the most market cap. It's got the biggest investors. But it is a laggard in terms of integrated reporting. So somehow we need to solve this, and one point of leverage is the asset management community. The largest five asset managers have 20% of all assets under management, and the top 20 have 40%. This means you only need to get a relatively small number of big asset owners and big asset managers and big companies to practice ESG integration. Companies focus on the material issues. Investors are starting to incorporate these in their decision making, but there's a lot of greenwashing.

Until portfolio managers think this stuff is important and asset owners put pressure on asset managers, you won't start to extend the time frame. When you leverage standards like SASB, then you will have the information that you need to create the capital markets that we need for the society we want to have tomorrow.

Creating a Sustainable Society

We wouldn't have the capital markets today without financial accounting standards and reporting requirements. Without frameworks like the IIRC, without standards for how you measure nonfinancial items, we're not going to have resource allocation decisions being made over a sufficiently long time frame to create a sustainable society. Companies and investors are absolutely fundamental to this international movement, and we need governments to set intelligent regulation.

One of the things that's interesting to me is that the influence and sophistication in the NGO [non-governmental organization] community have grown tremendously over the past 30 years. GRI, SASB—they're our conscience, the canaries in the coal mine. And you're seeing them much more actively engaged with companies and investors.

I think if we can get all four of these elements and then leverage tools like integrated reporting, if we can get boards to take a position on who the significant audiences are and the role of the corporation in society, if we can get ESG integration on both the corporate side and the investor side and change the narrative between companies and investors—that's how I think we get to capital markets that support a sustainable society.

Robert G. Eccles, PhD is a professor of management practice at Harvard Business School, Boston, Mass. The above is an edited transcript of his remarks at the conference.