

**CORPORATE GOVERNANCE
AND
CORPORATE SUSTAINABILITY REPORTING:
A VITAL LINK IN 21ST CENTURY ACCOUNTABILITY**

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Trust and confidence are key ingredients of a well-functioning market economy. ..We encourage the many initiatives underway, in national capitals, international financial institutions and by international standard-setting bodies, to strengthen governance standards and disclosure regimes.

***Fostering Growth and Promoting a Responsible Market Economy
A G8 Declaration, Evian, France, June 2, 2003***

If we are to join traditional and social values so as to generate a single language of [accountability], we need to begin with a new accounting system.

Robert A.G. Monks, The New Global Investors, 2001

In the final analysis, the free enterprise system exists at the pleasure of society, and the trust and confidence of [non-shareholder] constituencies is crucial to its productive functioning

The Conference Board, Commission on Public Trust and Private Enterprise, 2003

PRELUDE TO A NEW REALITY

The rise of corporate governance as one of the preeminent business issue in the early 21st century raises fundamental issues about the character of the modern corporation. How will it be managed, monitored, and regulated? How will be held accountable to its stakeholders? Who are these stakeholders? And how must boards and managers conduct themselves in an increasingly complex, global economy in which decisions and events become public knowledge at “internet speed.”

These debates will only intensify as the link between good governance and long-term value creation is better articulated and demonstrated. That good governance is both sound business and sound public policy is rapidly becoming conventional wisdom. Investors’ willingness to pay a premium for well-governed companies at the same time governments act to empower shareholders in such areas as executive compensation, stock options and election of board members illustrate the convergence of investor and public interests in support of governance reform.

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As these initiatives of this nature unfold, one cross-cutting theme that continually surface is disclosure: what information ought to be available, to whom, and when? It is an issue that predates the last three years of governance scandals, but there is little doubt that these scandals have propelled and sharpened expectations for the upgrading extant information regime.

As early as the 1970s, many observers were raising questions about the adequacy of conventional reporting as the cornerstone of corporate disclosure. Efforts to define and systematise “social accounting” and “environmental accounting” signaled an interest—at least among a few pioneering advocates and academics-- to stretch the boundaries of standard financial disclosures to embrace new kinds of information material to company stakeholders.

These efforts were the precursors to the “sustainability accounting” movement of the last five years. This movement is laying the groundwork for a new non-financial information structure to complement financial accounting while expanding into the new territory of environmental, social and economic (apart from conventional financial) disclosure.

At least two drivers area are energizing this movement.² The first is the view that financial accounting, while providing essential information pertaining to backward-looking performance—e.g. last quarter or last year’s revenues and earnings—falls well short of the forward-looking perspective that investors and other stakeholders need for informed decision-making. Because the 21st century business climate is profoundly different than that of the 20th century, it follows that the scope of material information must follow suit. HIV/AIDS in the workplace and communities is a stark example of such new boundaries. Unknown two decades ago, HIV/AIDS now threaten to undermine otherwise healthy companies, threatening investor interests while destroying whole workforces and communities. In a similar vein, payments to governments by resource industries, carbon emissions, anti-corruption practices and labour standards in the supply chain exemplify issues whose materiality is becoming increasingly evident.

The second driver is the emergence of sustainability itself as a core governance issue. Carbon emissions, labour standards and corruption are not only material. They also are as much governance issues as executive compensation and proper auditing of last year’s financial accounts.³ If one subscribes to this premise, it follows that sustainability accounting—exactly like financial accounting-- is an indispensable tool to informed decision-making and performance monitoring boards, management, and those responsible for advancing shareowner interests—pension fund trustees, institutional investors, asset managers.

² In parallel with the sustainability thrust, though with regrettably minimal interaction, financial accounting standards-setters have ventured into non-financial reporting various rubrics, including “intangible asset measurement” and “business reporting” However, these efforts to date have amounted to minor excursions from the pressing need to review certain aspects of financial reporting such as accounting for stock options and pension obligations.

³ For an examination of the governance-climate change linkage, see Robert Kinloch Massie, *The Irresistible Rise of Sustainable Governance*, World Economic Forum, Davos 2003.

EMERGING INTERDEPENDENCIES

Against this backdrop, it becomes clear that high standards of corporate governance depend on equally high standards of sustainability disclosures. And vice-versa.

Corporate governance defines the relationships between management, boards, shareholders and other stakeholders. Corporate sustainability reporting (SR) is an instrument for disclosing the performance of the corporation along non-financial lines, including (non-financial) economic, environmental and social. Good governance requires credible SR because SR helps identify the landscape of risks and opportunities to those that constitute responsible parties in realm of corporate governance. At the same time, strong SR flows from governance structures that value and encourage high standards of transparency.

Recent years have made these linkages increasingly evident. When either governance or reporting are weak, companies pay a high price in the form of loss of investor confidence, increased market volatility, greater tendency toward bubbles and busts, and higher cost of capital. In contrast, when information is complete, trustworthy and timely, the market responds favorably in terms of lower market risk, lower cost of capital, and higher price-to-book ratios.⁴

While these linkages are becoming increasingly visible, it would be premature to conclude that the mainstream financial community fully embraces them. Nonetheless, plummeting investor confidence and enormous losses in market value—some US \$7 trillion in the US alone-- have triggered unprecedented actions by regulators, and stock exchanges to elevate standards of accountability. Some of these are targeted explicitly at the quality and certification of financial disclosures such as US Sarbanes-Oxley Act of 2002. Others are directed at executive compensation, among the most controversial aspects of corporate governance, such as the new UK requirements for shareholder voting on compensation decisions by boards of directors. Still others are directed at the nature of disclosure itself, including expansion of traditional financials to cover non-financial information already appearing in corporate SRs. Examples of this is the Johannesburg Securities Exchange Code of Conduct adopted from the King 2 Report on Corporate Governance in South Africa, and the social and environmental disclosure requirements for companies listed on the Paris Stock Exchange as mandated by the new French Economic Regulation.

Though these and other concurrent initiatives are not linked in a formal sense, they collectively represent a sea change in accountability practices that will define corporate practices in the next decade and beyond. It is this “climate of accountability” that provides the stage on which the governance-disclosure story is being played out before the full range of corporate stakeholders.

⁴ Samuel DiPiazza Jr. and Robert G. Eccles, *Building Public Trust: The Future of Corporate Reporting*, 2002; Standard & Poors, *Transparency and Disclosure; Overview of Methodology and Study Results-United States*, October 16, 2002.

SIGNS OF RESOCIALISING

From a historical perspective, these trends are reminders of the genesis of the modern corporation that began some four centuries ago. In their original concept -- and even in their modern incarnation -- corporations are creations of the state. They exist within the framework of charters and laws granted by governments. They are, in the words of Robert Monks, indispensable entities in the market economy because they "...enable people to get things done."⁵ The current debates over corporate governance and accountability may be viewed as a reassessment of what these "things" are and how corporations should conduct themselves in getting them "done."

Historically, the public interest was always core to the corporate mission, beginning with the first royal chartered corporations in the UK and the Netherlands. As their size, complexity and influence evolved, and as shareholders became more numerous, diffuse, and remote, management increasingly played the dominant role in executing the activities of the company. This dominance was reinforced by legal protections that emerged in the late 19th century, most notably limited liability, or protection of owner-investors from legal claims beyond the value of the shares they own. Further, corporations in the US and, to varying degrees in other industrial countries, were assigned the rights of a "natural person" with protections equivalent to those applicable to individuals, such a freedom of speech and the ability to make political contributions.

At the same time certain responsibilities have evolved, particularly during the last 100 years of regulatory actions that set ground rules from everything from financial reporting, minimum wages, worker health and safety, anti-trust protections, product safety and political donations. These rules have evolved in response to actual or potential corporate abuses of the public trust embodied in company law and charters.

Today's debates over corporate governance and accountability may be viewed as the most recent manifestation —arguably the most far-reaching since the 1930s—of societal uneasiness with the direction of corporate drift from its social roots. Anti-trust, securities, and labour regulations are earlier manifestations. Today's debates once again raise the questions of rights and responsibilities, control and oversight, of corporations, especially large multinationals whose conduct affects millions of shareholders through the institutional investments to which they contribute.

While the themes are familiar, there are qualitative differences between earlier and today's accountability debates. As never before, the spotlight is on one of the most fundamental of all issue in corporate governance: how do we measure performance? Is it simply a balance sheet and earnings statement of the traditional kind? Is it share price? Economic value added? Or is it the economic, environmental and social capital created by the company over the long-term, reflecting the public interest lineage of the modern corporation?

⁵ Robert A.G. Monks and Nell Minow, *Watching the Watchers: Corporate Governance for the 21st Century*, 1996, 9

That these questions are being raised with increasing frequency attests to the deep dissatisfaction of stakeholders with the current state of performance measurement. And that so much attention is being devoted to non-traditional, non-financial aspects of performance suggests that performance measurement is rapidly approaching a watershed that will redefine the models, methods and metric of performance measurement in the coming years.

FALSE DICHOTOMY

How will new performance approaches take shape? To answer this question requires reconciliation between the public interest roots of the corporation with the current emphasis on shareholder value as the yardstick by which to assess performance.

Monks and Minow offer a key observation: “Corporations must have as their primary and overriding goal the generation of long-term value. A commitment to the satisfaction of employees, suppliers, customers and the community is essential for achieving this goal.” Indeed, the rationale for “long-term value creation” as the purpose of the corporation is becoming more compelling in view of corporate ownership trends since the 1970s.⁶ In the US, individuals held 80 percent of stock in the early 1970s. By 2000, institutional investors—public and cooperative pension funds, corporate and union pension funds, mutual funds and bank trusts—owned 60 percent of all stock. Presently, about 45-50 percent of all Americans are vested in some kind of institutional stock ownership.

The consequences of these trends are profound for governance in general, and for performance measurement in particular. Ownership blurs the distinction between shareholder and stakeholder. Shareholders, it turns out, *are* stakeholders, and vice versa. They are employees, suppliers, customers, and the public at large, all with a strong interest in seeing assets managed with a long view that enhances their assets over the 10, 20 and 30 year time horizon. It is in the self-interest of such shareholders to maximize the economic, environmental and social benefits of companies in the portfolios of pension funds and other investment instruments in which they hold ownership. This is the case because shareholders are neither indifferent nor detached from such impacts. Instead, as employees, customers and community members, they are directly affected by the goods and bads that attend company activities. Workplace practices, product safety, service and product pricing are not an abstraction—they are decisions who ramifications have direct and measurable consequences for the shareholder/stakeholder.

Thus, we see that a false dichotomy between shareholders and stakeholders is at odds with emerging ownership realities in the US, the UK and, to a lesser but increasing degree, other industrial nations. The implications of this for performance measurement—and reporting—now become clear. If long-term value creation concurrent with maximization of economic, environmental and social benefits is sought

⁶ James P. Hawley and Andrew T. Williams, *The Rise of Fiduciary Capitalism*, 2000, 1.

by shareholder/stakeholders, then performance measurement must be capable of capturing these multiple dimensions of corporate performance. This is the essence of SR.

Compare this perspective on performance measurement with share price maximization that occupies center stage among key indicators. Such maximization may be in the interest of some segments of the financial community or the executive holding stock options, but it has little to do with long-term value creation. Share price is subject to the vagaries of short term market trends and macro economic conditions, currency exchange fluctuations, mergers and acquisitions, and changes in laws and regulations affected specific products, services or sectors. Share prices also reflect short-term earnings, which themselves can be manipulated by accounting practices, even within the limits allowable under national and international standards.

In contrast, long term value creation depends on underlying value drivers that, in turn, reflect knowledge, competencies, innovation, strategy, brands and other intangible assets of the firm, including the quality of governance. These intangibles are characterized by two attributes: (1) they are created, preserved and enlarged in part by the quality of the firm's relationships with its stakeholders; and (2) their measurement and reporting lags well behind the conventional financial indicators.

Paradoxically, the information most relevant to assessing long term value creation is most deficient under extant reporting regimes. And information that is most abundant regulated, and accessible – the balance sheet, profit and loss statements—offers relatively little insight into the prospects for long term value creation. This imbalance will can only be corrected through the creation of a generally-accepted, non-financial reporting standard with a standing equivalent to international financial reporting standard.

SUSTAINABILITY INFORMATION AND BOARD EMPOWERMENT

If long term value creation is the purpose of the corporation, then all governance actors—boards, management, shareholders—must have access to credible information that enables a penetrating view of the company's value drivers. Without such information, good governance cannot occur because decisions cannot reflect the long term prospects of the firm. Decisions are only as sound as the information upon which they are based. Achieving long term value creation necessitates information that depicts the long-term prospects for the firm. Share price, quarterly earnings and even annual balance sheets do not provide such a perspective.

This reality has implications for any board that strives to act as a responsible fiduciary. Over reliance on financial reporting is sometimes likened to operating a motor vehicle by excessive use of a rear view mirror. With attention focused on the past instead of the future, potholes, oncoming vehicles and other unwelcome and hazardous surprises are inevitable. In contrast, a tidy and ample windshield coupled with a multi-instrument dashboard and a roadmap, provides the operator with the vision and tools needed to reach a destination smoothly and efficiently. This forward look is what strong SR offers to those responsible for achieving long-term value creation.

Why, more precisely, is this the case? Sustainability reporting in its best form is about measuring value creation in the sense of tracking additions to social capital (e.g. the quality and quantity of alliances and partnerships), human capital (e.g. the quality and quantity of human knowledge and skills), environmental capital (e.g. the quality and quantity of biological, air and land resources) and economic capital (the mixing of technology, labour and capital to enlarge the pool of marketable assets). Blending these into a portrait of the company enables a board to assess prospects along various dimensions:

- Risk assessment: risks to business derive a wide array of economic, environmental and social conditions, from climate change to HIV/Aids to labour practices among suppliers. Sustainability reporting enables boards to appraise how astute management is identifying and mitigating risk
- Opportunity assessment: firms constantly scout for new markets for products and services. Their success in doing so depends on their capacity to enlarge market share, identify emerging markets and establish a foothold in such markets. Sustainability reporting provides boards with the ability to assess the acuity of management in identifying and reacting to business opportunities
- Intangible assets: intangible assets are lie at the core of competitive advantage, and are thus of critical interest to shareholders. But they also are of fundamental importance to workers, suppliers, advocacy groups, and communities who have a vested interest in the quality of quantity of intangibles such as human and social capital, partnerships, brands, and reputation. Sustainability reporting provides a window on how firms define, cultivate and enlarge their stock of intangible assets

To be clear, sound information is not the only determinant of sound governance. Many other variables, embodied in recent legislative and regulatory initiatives, are at work: the quality and independence of boards; the integrity of financial audits; and the nature of compensation incentives facing the CEO. Nonetheless, the right information at the right time is a precondition to good governance. Without it, even the most qualified boards and managers cannot appraise risks and opportunities essential to delivering long term value.

THE WAY FORWARD

It is a slow and diffuse process, but reference to sustainability in general and SR in particular is beginning to appear in diverse quarters. When taken together, these appearances suggest movement toward a threshold, a critical mass, that gradually will move SR into the financial mainstream. Illustrative examples include:

- a commitment by the European Community to identify by 2004 a generally accepted framework for sustainability reporting
- the launch of sustainability reporting guidelines by Australia based on GRI
- reference to GRI by asset managers such as Henderson Global Advisors and ISIS Asset Management in shaping stock portfolios

- new governance rating products by Standard & Poors, Fitch, the Global Corporate Governance Benchmark affiliated with the World Bank/OECD Corporate Governance Forum, and GovernanceMetrics, with the latter incorporating and crediting GRI reporting
- the GRI reference by South African King 2 Committee Report on Corporate Governance, and the sustainability disclosure requirements of the Paris Exchange
- A dozen shareholder resolutions in the US filed by institutional investors seeking GRI reports from large US multinationals

Corporate governance is entering a period of democratization. Shareholder activism, spurred by Enron and its successors, is intensifying. Governments, through legislative and regulatory mechanisms, are undertaking initiatives to restore trust in the markets. Expectations and obligations of boards are rising as governance moves to the center of the public policy and business agenda.

Information is a critical ingredient to the long-term success of governance reform. The best intentioned shareholder, trustee and board member need non-financial information that, at present, is simply not available in a routine, credible and efficient fashion. The intersection of this need and this shortcoming underpins the case for a generally accepted, globally recognised SR framework.

Governance is a sustainability issue because when governance fails, the repercussions are felt across a wide range of stakeholders, including but not limited to shareholders. The corollary also is true: sustainability is a governance issue. Sustainability is intertwined with long term value creation, the central purpose of the company and for which boards and management are held accountable. Attentiveness to sustainability issues of an economic, environmental and social nature are essential to the firm's obtaining and retaining its license to operate, to fortifying brands and reputation, to attracting top talent, and to managing risks and opportunities that are decisive in long-term business success.

Not all sustainability information is relevant to governance, and not all aspects of governance are relevant to sustainability performance. But the experience of the last five years indicates critical shifts in the scope of materiality, gradually leading to a situation where there are far more commonalities than differences in governance-relevant and sustainability-relevant information. This is a healthy trend that in the coming decade promises to yield, for the benefit of all stakeholders, both stronger corporate governance and stronger corporate performance.