EIRIS Empowering Responsible Investment

Response to Financial Reporting Council's Discussion Paper:
Thinking about disclosures in a broader context

Details on the respondent EIRIS

Ethical Investment Research Services (EIRIS) Ltd researches the environmental, social, governance and ethical aspects of over 3,000 companies globally. EIRIS provides services to asset owners, asset managers, stock exchanges, private client brokers and non-profits worldwide. EIRIS is solely owned by the EIRIS Foundation, a leading UK charity working in the area of responsible investment. The Foundation has 30 years' experience of providing free, objective and trusted information on ethical finance to charities and members of the public. A social enterprise, its mission is to empower investors with independent assessments of companies and advice on integrating them with investment decisions.

Contact Name: Stephen Hine (Head of Responsible Investment Development)
Contact Address: 80 – 84 Bondway, London, SW8 1SF
Contact Email: stephen.hine@eiris.org

A. Response in summary

EIRIS welcomes the Financial Reporting Council's ('**FRC**') discussion paper which seeks views on disclosure and materiality in financial reporting and suggests that there is need for a disclosure framework (the '**Discussion Paper**').

The Foreward sets the Discussion Paper in context, describing it as a response to commentary about the purported decreasing relevance and increasing complexity of financial reports. One of its aims is stated to be to curtail *"the piecemeal approach to disclosures that is likely to continue as a result of future developments in disclosures, such as the forthcoming EC proposal on non-financial information and integrated reporting."*[1] Yet, as the FRC acknowledges, "improving disclosure is a shared responsibility". [2] Indeed, effective reporting will only be established with input from multiple stakeholders.

Disclosure and reporting have moved forward in recent years. The current direction for discussion, led by organisations such as the International Integrated Reporting initiative (of which EIRIS is an investor network member), the Global Reporting Initiative on G4, the European Commission and the Department for Business Innovation & Skills in the UK, has been the quality of reporting, narrative reporting and integrated reporting. The FRC's input is particularly valuable as an accounting and actuarial overseer and corporate governance standard-setter.

In light of the above mentioned reporting developments, we would expect that it would be counterproductive to now remove items from the financial report. However, as the Discussion Paper suggests, perhaps there is a need for corporates to revisit which items rightly belong in corporate reporting, as opposed to financial reporting.

It is good to raise concerns in order to move forward collectively and to constructively contribute to the development of best practice reporting. Discussion of a disclosure framework would seem like a useful way forward, particularly if it helps gain the confidence of accountants and actuaries, for whom the future direction of reporting could offer

[1] Financial Reporting Council, 'Thinking about disclosures in a broader context' discussion paper October 2012, p.2
[2] Financial Reporting Council, 'Thinking about disclosures in a broader context' discussion paper October 2012, p. 4

expanded scope for verification. It is also important to strive towards standards and principles that are globally applicable, given how many companies operate on an international basis.

'Integrated' reporting (with the appropriate metrics) would permit and embed externalities into mainstream accounts and reporting. This would enable valuation of currently hidden costs (e.g. climate change and biodiversity) and the application of the 'pollution pays' principle (equally applicable for social issues).

Concise and material information can aid investor decision-making, but investors also need the workings behind top-level statements, evidence for management decisions and wider information. A comparison of both the top-level statements (in financial reports) and the background data (in corporate reports) provides investors with insight.

As the Discussion Paper suggests, where this information is communicated is important. In EIRIS' view, differentiation could be made between financial reports with top-level financial analysis and separate, more detailed corporate / stakeholder reports. Having the detail somewhere is vital. Mainstream investors, such as those who are signatories to the Principles for Responsible Investment, are increasingly looking for significant ESG issues to be fully and appropriately reported upon.

A summary of EIRIS' response follows and we explore these with reference to the Discussion Paper in the following paragraphs:

1. Some environmental, social and governance (ESG) risks can be financially 'material' to a company
2. ESG risks, whether material or not, may have a potential financial impact on the health of a company. Some of these risk areas, typically described as 'non-financial' or 'extra-financial', are easier to monetise than others.
3. ESG risks that are found to be financially material to a company should be included in financial reports. They are most likely to appear in management commentary or in the most nuanced corporate governance analyses. Material indicators reported upon should not just be current ones, but be anticipating longer-term risks and opportunities that enhance value creation.
4. Non-material risks, including non-material ESG risks, should be included with other wider information in reports outside the financial report, e.g. the corporate CSR / stakeholder / sustainability reports. This detail is valuable and should not be lost.
5. A comparison between top-level management analysis of key risks in a financial report and the underlying information found in corporate reports may reveal a discrepancy between management risk analysis and investor risk analysis. This provides investors with an assessment of corporate management.
6. Guidance would be welcome on the definition of 'materiality'. However, this is a fundamentally intuitive measure that will evolve over time. If defined, it needs to permit interpretation based on individual business models.
7. EIRIS supports the general movement towards integrated reporting. The movement offers an opportunity for accounting bodies to develop their scope and assurance role, as the evolving content of financial and corporate reports will need verification and assurance in the future. Whilst it may be counterproductive to suggest removal of items now from financial reports, the Discussion Paper's suggested disclosure framework may encourage afresh consideration of what is sufficiently material to be included in financial reports.

B. What type of user is EIRIS and what disclosures are important to investor research organisations?

As a leading global provider of research on corporate ESG performance to investors, EIRIS uses financial and corporate reports (as well as other media sources and information directly from companies) to monitor, assess and analyse corporates, engage with them and ultimately to report to investors on their performance. Investors use this information in their investment strategies. With regard specifically to financial reports, EIRIS primarily uses disclosures from the management commentary and governance sections and, less frequently, those in the financial statements.

Investors use financial and corporate reports to assess risks and value companies. The management statement, governance disclosures, financial statements, and notes to financial statements will all have value for investors, as described by the FRC, in "making resource allocation decisions and assessing management's stewardship."[3]

C. Disclosure Themes - Can ESG risks be financially relevant?

In the Disclosure Themes table in the Discussion Paper the box titled 'non-financial information' states that the term is used to refer to *"information such as resources and relationships, environmental matters and management's expectations of future performance. This type of information is often included in management commentary."*[4]

What is described as 'non-financial information' often has a potential impact on the financial health of a company. Such information might include environmental, social and governance risks (or opportunities) and evaluation of these risks by the company. Often financial value can be placed upon 'non-financial information' by analysts.

The Discussion Paper asserts that there is a need for debate about "the types of non-financial information that users need to be included in a financial report".[5] From our perspective, this is fundamentally about whether a risk is financially significant. Management should be required to inform investors (and other relevant stakeholders) of key risks to a company, including any ESG risks that are financially material.

D. Disclosure Themes - When does an ESG risk become financially 'material'?

There is a need to balance materiality and sustainability. There is a danger that some key sustainability issues are not seen to be material at all, or to be sufficiently material for some companies to report on them.

Materiality will vary from company to company. Here are two examples of where ESG risks could be financially material.

[3] Financial Reporting Council, 'Thinking about disclosures in a broader context' discussion paper October 2012, p.14
[4] Financial Reporting Council, 'Thinking about disclosures in a broader context' discussion paper October 2012, p. 17
[5] Financial Reporting Council, 'Thinking about disclosures in a broader context' discussion paper, October 2012, p. 17

1) ESG risks might be 'material' when central to an organisation's business model. To illustrate this, we refer to Unilever's 2011 Annual Report and Accounts which identify its aim to double in size whilst reducing its environmental footprint. Investors will be looking for information in the financial report to support the case made that this is central to its financial business model:

"Our vision is to double the size of Unilever while reducing our environmental footprint. The two elements of this are interlinked. Our growth ambition is dependent on operating sustainably. These two aspects of the vision shape and form our business model. ….When we wrote in our previous report that 2011 would be challenging, we could not have known how right that prediction would be. The world has been through a year of almost unprecedented turmoil and uncertainty, and is facing some serious challenges. This in turn frames the way we must manage our business and the issues we face. Short-term economic pressures have dominated 2011, with major instability in the Eurozone and a weak recovery by the US economy …. 2011 also saw a tragic series of natural disasters, from the earthquake and tsunami in Japan to the famine in the Horn of Africa. Each one required a response from us at a humanitarian, employer and operational level. Furthermore, the interdependent challenges of food security, poverty reduction, sustainability of resources, climate change and social and economic development have never been greater. We believe that many of these factors will continue for the medium term, and that this level of volatility and uncertainty is the 'new normal'. Our business model has been evolved as a response to this operating environment, as we address the prospect of another 2 billion people on the planet by 2050."[6]

2) ESG risks may also be financially material if a company's business model relies on supply that is affected by external sustainability variables. These variables may change in significance over time, as may concerns from consumers, civil society or regulators about such variables, which could result in the issue becoming sufficiently material to warrant reference to it in financial reports. For example, whilst fishing is obviously a sustainability issue, fish may not be anything like a leading material risk for supermarkets (as opposed to fish processors), yet unless supermarkets adopt sustainable fishing practices there could be no more fish.

E. Financially material ESG risks should be included in financial reports

The Discussion Paper suggests that some question the inclusion of certain indicators, such as carbon emissions, in financial reports.

We are not necessarily in favour of new indicators. However, it could be argued that in the case of a carbon indicator, as carbon can be a real material risk and cost to a company, which can be monetised, it is of sufficient significance to be included in financial reports.

Climate change will create clear winners and losers across the investment universe. The findings of the Stern Review, which Lord Stern now claims underestimated the risks posed to the economy by rising temperatures, mean that it is inconceivable that climate change will not have an impact. [7] Therefore, it would be remiss not to report on this in business terms where relevant. Many investors are already interested in corporate response to climate change and interested in engaging with them to improve their performance.

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[6] Unilever, Annual Reports and Accounts 2011: Our Business Model for Sustainable Growth section
[7] Nicholas Stern, *The Economics of Climate Change – The Stern Review,* 2007. See also Heather Stewart and Larry Elliott article, "Nicholas Stern: 'I got it wrong on climate change – it's far, far worse'", *The Observer*, Saturday 26 January.

There are other issues (such as water, biodiversity, bribery, operations in regimes with human rights challenges etc.) which will most likely be financially material for some companies. Again, one would expect that these sorts of issues would be addressed in a financial report to the extent that they can be.

Some ESG risks can be more easily monetised than others. We recognise that sometimes it may be hard to find the correct indicators for ESG risks in order to report them in a financial fashion. If they are reported in a financial fashion, it may be possible to attach a price to them. If it can be monetised and it is material to a company, a risk should be included in a financial report.

As mentioned above, in light of recent reporting developments, it would seem counterproductive to now remove items from the financial report. However, the Discussion Paper perhaps rightly indicates that corporates should think afresh about what is the purpose of financial reports.

How the Discussion Paper defines 'financial report'

The Discussion Paper states that there is the need to 're-focus' disclosures in financial reports on their purpose. The purpose of financial reports is described as "providing investors with information that is useful for making their resource allocation decisions and assessing management's stewardship".[8] EIRIS would like to clarify how ESG risk information supports both these purposes.

Resource allocation decisions – Analysts want to know what are the key risks, have they been identified by management, are they reflected in the bottom line of the company. All of this will be in the context of changing business environments and strategy. Part of making a compelling business case to investors is if a company has analysed all key risks from so-called 'externalities' and doing so in a forward-looking manner using ESG factors as part of long-term business strategy and planning.

Assessing management stewardship - The inclusion or exclusion of material non-financial information in a financial report can indicate the quality of, and stewardship by, management. Information about risks that are less significant can be contained in separate corporate reports. A comparison between the top-level analysis and crystallised figures of the financial report with the evidence and working behind such analysis (in the fuller, more detailed corporate reports) provides investors with an assessment of management. The working is important, even whilst being placed elsewhere. Without this working, investors lose information for analysis and they also lose a resource with which to hold management to account.

How the Discussion Paper defines corporate governance disclosures in financial reports

'Non-financial' information may also be of significance for corporate governance disclosures by management. The Discussion Paper identifies corporate governance as an integral component of a financial report. It suggests additional criteria for governance disclosures by

[8] Financial Reporting Council 'Thinking about disclosures in a broader context' discussion paper, October 2012, p. 14

management, including "*setting the company's strategic aims, supervising the management of the business and reporting to shareholders on their stewardship*". [9]

A nuanced view of corporate governance by leading corporate practitioners may look at a broader set of governance issues. Environmental and social (E&S) management can be seen as an extension of governance. Indeed, board level responsibility for E&S issues is deemed to be best practice by many investors.

F. Definition of 'materiality'

The Discussion Paper states that there is a need for guidance on how 'materiality' should be applied to disclosures. We would welcome guidance on considerations a company should take into account to determine what is material. Without guidance, the information included in financial reports may not be comparable or useful.

Materiality will be hard to define as it is essentially an intuitive factor. It is important that definitions of materiality reflect long-term business strategy and value creation. Materiality will therefore change over time. Any definition should also not be too prescriptive, but rather allow for application to each company's individual business model.

Equally there is a danger that a lax definition would allow potential misapplication by a company who ignores key risks in statements.

Guidance that suggests different levels of materiality for different types of disclosures in the financial report (management commentary, corporate governance and financial statements), as suggested by the Discussion Paper, may be worth exploring, but we would reiterate that this should be guidance, rather than prescription.

We would suggest avoiding a definition of materiality that precludes the inclusion of information in financial reports which are best practice according to developing standards from the Global Reporting Initiative, UK government Department BIS, and the European Commission etc.

G. Integrated reporting is an opportunity to widen the scope of verification / assurance roles of auditors

External auditing brings credibility, greater accountability and transparency to the reporting process.

As financial reporting moves generally towards integrated reporting, there may be an opportunity for auditors to audit greater amounts of narrative information in integrated financial reports. EIRIS would suggest that auditors' reports should not be limited to only stating if what has been audited is true, but also making suggestions for improvement in scope, detail and the quality of reporting. This would provide an extra layer of reassurance for report users (as long as the auditor responsibility and independence are credible).

In EIRIS' response to the FRC's Effective Company Stewardship consultation in 2011, we supported the FRC's proposal that the Financial Reporting Review Panel's remit should be

[9] Financial Reporting Council 'Thinking about disclosures in a broader context' discussion paper, October 2012, p.22

extended to cover the whole of the narrative content in the annual reports and accounts, and similarly that the Audit Inspection Unit's supervision should extend to the auditor's consideration of the narrative content in annual reports. In our response we also noted the proposed amendment to the standards governing the provision of reports by auditors including 'the judgements made in the audit plan about what is of material significance'.[10] It is important to encourage auditors to recognise that ESG factors can potentially be material to the financial sustainability of a company; this could be achieved through the provision of standards and training.

H. Conclusion: Looking forward

The potential for change through the integrated reporting initiative is immense and its development so far to be highly commended. Integrated reporting would permit and embed externalities into mainstream accounts, enabling valuation of currently hidden costs. Integrated reporting will drive disclosure of information that is useful for integrated analysis by encouraging and linking the disclosure of material financial, management and sustainability information.

In light of recent initiatives, it would appear counterproductive to suggest removal of substantial items from financial reports at this stage, but it may be that corporates need to reflect afresh on which indicators are included in financial reports. We support the inclusion therein of material financial risks, including ESG risks if appropriate. Material indicators reported upon should be current ones and those anticipating longer-term risks and opportunities that enhance value creation.

One way to encourage such reflection would be to create guidance on materiality and its application to disclosure. A fundamentally intuitive measure, materiality will evolve over time and needs to recognise individual corporate business models.

However, in order to fully analyse the key disclosures by management, investors are likely to need more detailed information than the disclosures in financial reports. EIRIS therefore supports integrated financial reports that are complemented by separate reports (corporate / stakeholder / sustainability) with more detailed information. These should be linked to from the integrated financial report. The FRC will no doubt continue its work with organisations such as the International Integrated Reporting Council, in order to further develop the content covered in each type of report.

The FRC's suggestion of an international disclosure framework is to be commended; it could further coordinate the different strands of recent reporting developments that are moving forward so constructively.

31 January 2013

[10] Financial Reporting Council, '*Effective Company Stewardship*' consultation, January 2011, p. 15