Local Authority Pension Fund Forum

Response to European Commission Directorate General For Internal Market and Services Public Consultation on Disclosure of Non-Financial Information by Companies

The Local Authority Pension Fund Forum (LAPFF) was set up in 1991 and is a voluntary association of 52 local authority pension funds based in the UK. It exists to promote the investment interests of local authority pension funds, and to maximise their influence as shareholders to promote corporate social responsibility and high standards of corporate governance amongst the companies in which they invest. The Forum's members currently have combined assets of over £90 billion.

The Forum has taken the opportunity below to provide our view on those issues it considers relevant to its activities.

Draft Response

1) How would you consider the current regime of disclosure of non-financial information applicable in your country?

- **Very poor.** [N.B. Where choices are offered in this survey the Forum's response is highlighted in bold].
- Poor
- Sufficient
- Good
- Very good

Please explain. (In replying to this question, please provide information on what way current reporting provides useful information, and to what extent it is sufficiently tailored to the circumstances of the company. Please also comment on whether you find non-financial information useful for the decision-making of a company).

Non-financial reporting has not kept pace with the demands of primary users of corporate reports in the Forum's opinion.

The accounting system that underpins current reporting does a good job of measuring the book value of physical assets. However, we believe it does little to help users appraise the value of assets for which there is no internal market price (business processes and corporate culture, for example), but which contribute the greater part of value creation or destruction in the modern economy.

Baruch Lev has documented a growing disconnect between market values and financial information – and speculates the provision of additional non-financial information is currently insufficient for the proper valuation of listed companies.[1]

In our opinion, there are three primary reasons for this:

i. Corporate reporting has changed little in comparison to users' evolving understanding of how businesses compete and make money,
ii. The pace of change in the competitive landscape has outstripped efforts to encourage more and better non-financial reporting, and
iii. Stakeholders have become increasingly interested in corporate behaviours (as opposed to outcomes).

Taken together, we believe this accounts for the gulf we consider exists between what companies report (or are required to report) and the ingredients of business success that concern stakeholders.

We are therefore not surprised that financial information alone is unable to explain company valuations and asset price movements, or that the provision of non-financial information has been unable to fill the gap.

<u>How Businesses Compete and Make Money</u>

Companies compete, succeed or fail, and create value or destroy value on the basis of the quality of their organisational capital: how this meets customer needs, how this sustains and protects competitive advantage in doing so, and how it meets expectations for responsible behaviour. They channel that value to lenders and shareholders through high standards of governance.

In our opinion, this *is* – or *should be* – the substance of non-financial disclosure.

It appears to us that reporting companies either do not acknowledge this, or they are reluctant to move beyond the status quo.

[1] See, for example, Baruch Lev and Suresh Radhakrishnan, The valuation of organization capital, June 2004, http://pages.stern.nyu.edu/~blev/docs/TheValuationOfOrganizationCapital.pdf

We are encouraged by developments in the standard of disclosure around governance and social responsibility. Stakeholders are now much more informed about how companies are run and whose interests are served than they were, say, 10 years ago.

Nonetheless, we believe companies can go further. Current non-financial reporting in these areas tends to be restricted to policies and processes. *When stakeholders receive additional insights into behaviours and outcomes we believe they will be in a far better position to appraise standards of governance and responsibility, and to distinguish between corporate performance in this regard.*

In terms of delivering insights into how their organisational capital transforms different capabilities into a durable value proposition, it appears to us that companies are more reticent to provide stakeholders with useful information about how; for example, human resources are combined with physical resources to create innovative solutions to market needs and secure competitive advantage. (We define information as any data a stakeholder can use to inform predictions of future behaviour. Accordingly, we classify data that does not do this as noise).

It is likely companies are concerned about disclosing sensitive information to competitors. This is a common response in our engagements and one we understand.

Nonetheless, our message to such companies is they are leaving value on the table when they prevent stakeholders from fully appreciating how their business models work, and the true value of organisational capital lies, not in what they do, but in how they do it – a tacit advantage competitors cannot get at via public disclosure.

Pace of change

Geoffrey Moore observes markets were harder to penetrate in a prior era, thereby slowing the pace at which commoditisation could erode established innovations.[2] This allowed businesses to build more durable competitive positions. Today, open markets have increased the pace of displacement so that innovation cycles must come more rapidly.

In face of this, companies spend on facets of their organisational capital – such as employee training, staff engagement, R&D, knowledge sharing, and brand management - to either maintain their competitive position or enhance it. The cycle of such spending is becoming more urgent. Yet investments of this type are expensed rather than capitalised on the balance sheet, which means as the pace of change accelerates a call is made on companies to complement traditional financial disclosures with value added non-financial information.

In our view, companies have not met this call.

Corporate Responsibility

Stakeholders, including the investors and asset owners that comprise the Forum are increasingly interested in how companies conduct business and where they rank in terms of corporate citizenship with respect to, for example, issues of sustainability.

- For some this is a question of whether a company is of investment quality with regards to certain standards of environmental, social and governance (ESG) performance.

[2] Geoffrey A. Moore, *Dealing With Darwin: How Great Companies Innovate At Every Phase of Their Evolution*, Portfolio, May 2008

- For others disclosure is an essential requirement to engagement designed to encourage higher standards of ESG performance.
- And for others still CSR information is an essential ingredient in asset valuation (although, in our experience, CSR reports are rarely a useful source of ESG data in this regard).

In this context we would encourage companies to explain how their CSR policies align with and support their strategies – something which is almost entirely absent from current reporting.[3]

We also caution against the approach used by some reporting companies, which appears to us to have become an annual restatement of boilerplate text relating to generic, rather than company-specific risks and opportunities.

With regards to whether we find non-financial information useful for the decision making of a company, it is not for us to say.

Nonetheless, our experience of analysing and engaging with companies suggests it is of critical importance. Indeed, given our remarks above, it seems self-evident to us that managers should develop the capability to assess the expected return on investments in organisational capital in order to allocate capital in a productive manner.

Moreover, we want the professionals who invest on our behalf to pay attention to management's capability in this regard when they make their investment decisions.

2) Have you evaluated the effects, and costs and benefits, of any current corporate disclosure of environmental and social information? (Compulsory)

- **Yes**
- No
- No opinion

Please explain

Viewed narrowly, the costs and benefits of disclosure depend on whether they are viewed from a company or investor perspective. More widely, the benefits to companies can be seen in a greater understanding and positive incorporation of a whole range of such metrics in supporting corporate strategy. The corollary is an increased investor understanding of strategic focus and related company initiatives. Where this understanding is poor, companies must invest more resources in tackling shareholder concerns. For some the costs may escalate when the company must face shareholder unrest, including when concerns are escalated to a resolution being filed at a company AGM.

3) If you think that the current regime of disclosure of non-financial information should be improved, how do you suggest that this should be done? Please explain.

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[3] See, for example, Michael E. Porter and Mark R. Kramer, *Strategy & Society: The Link Between Competitive Advantage and Corporate Social Responsibility*, The Harvard Business Review

In the UK context, the Forum' commitment to improving the quality of corporate reporting is shown through its support of the Accounting Standards Board Reporting Statement[4] as the only available best practice guidelines for Business Reviews.

The Forum considers that these guidelines provide specific emphasis on certain factors to guide directors in providing the most useful disclosure for shareholders. For example, the guidance refers to the provision of forward looking information prepared 'so as to assist the members of the company to assess the strategies adopted by the company and the potential for those strategies to succeed.' In our opinion, much reporting is dedicated to telling shareholders what a company does rather than how it creates and maintains a competitive advantage over rivals – which we believe is an essential element in the equation for value.

On environmental and social reporting, the OFR guidance asks for information about the extent to which environmental and social policies have been successfully implemented. The Forum believes that although a substantial proportion of companies refer to environmental, social and governance (ESG) matters in setting out their strategy, few companies comment on how their ESG performance contributes to this strategy and further make the consequent significant link to performance.

These themes are further developed in the Forum's feedback to the UK BIS consultation on narrative reporting, October 2010, a copy of which we provide as part of this submission.

We also support the notion of encouraging institutional investors to evidence their behaviour as responsible investors, particularly with regard to demonstrating that they integrate the consideration of ESG factors into their investment decisions. (See also our answer to question 10).

4) In your opinion, should companies be required to disclose the following (check all relevant boxes):

- Whether or not they have a CSR policy, and if they do, how they implement that policy and what the results have been.

  Yes

- The principal business risks and opportunities arising from social and environmental issues, and how they are taken into account in company strategy.

  Yes.

- Key information regarding issues such as employee engagement (e.g.: employee training policy, equality, and diversity, etc); customer satisfaction (e.g.: customer loyalty), public perception of the company (e.g.: stakeholder dialogue; environmental policies (e.g.: energy efficiency, waste reduction); and innovation (e.g.: R&D expenditure).

  Yes.

- **Other**

[4] http://www.frc.org.uk/asb/technical/operating.cfm

Other, please specify:

We would also encourage companies to report on the following:

i. The nature of their organisational capital, including the company's culture,
ii. How they ensure the quality and fit of staff in their recruitment processes,
iii. How they manage individual and team performance,
iv. How their succession planning works,
v. How they measure the adequacy of health and safety, and risk management processes beyond using outcome data, and
vi. How they use non-monetary rewards to attract, retain and motivate staff.

Please explain

Organisational Capital

In the 1930s Benjamin Graham, the father of investment analysis, taught the value of a firm could be extracted by investors from analysis of a company's financial statements. In this sense, non-financial information was not required to inform intelligent equity investments.

Although many practitioners subsequently came to understand business value could permanently exceed the value of assets on the balance sheet, it was arguably not until 1980 that the next material advance in investment analysis came.

Michael Porter's groundbreaking work - *Competitive Strategy: Techniques for Analyzing Industries and Competitors* – stressed the importance of industry selection in determining business success and, by inference, encouraged investors to think critically about the strategic ingredients of competitive advantage.

Nonetheless, *today*, few serious investors consider company valuation without analysing how companies combine *internal* (tangible and intangible) resources to meet to create value for customers and stakeholders within the external context set by the industry in which they operate.

Corporate reporting may be used to grant insights into Porter's original conception of the derivation of competitive advantage (company's tend to comment on industry trends, etc). However, in our view, little is dedicated towards enabling report users to truly understand how a company competes and makes money from the perspective of how its organisational capital fits together, and/or how the company creates an appropriate culture to foster and support its performance.

Quality and fit of staff

Much is made by stakeholders (and therefore by companies) of how employees are paid and how much they are paid.

Nevertheless, the evidence suggests that what and how people are paid plays only a small part in their performance compared to the context (or culture) within which they perform, and whether they possess the right skill set and cultural alignment with the firm.

Companies currently disclose very little information about how their recruitment process supports their strategies and cultures, or on performance in regard to the success (or not) of their recruitment practices.

Individual and team performance management

PricewaterhouseCoopers reports a considerable body of research shows the effectiveness of remuneration arrangements is highly dependent on related areas such as the quality of performance management.[5] Nonetheless, companies disclose very little information in this regard.

Succession Planning

In our view succession planning is unlikely to be universally important to business performance. (Numerous studies have shown that when CEOs die unexpectedly stock prices go up rather than collapse.)[6i]

Nonetheless, there are circumstances in which we believe succession planning is likely to have material implications for corporate and stock price performance:

i. When a company chooses not to comply with the Combined Code and installs an incumbent CEO as Chairman. (See, for example, Stuart Rose's dual role appointment at Marks & Spencer and the Forum's subsequent engagement with the Company).
ii. When a company has an iconic CEO.
iii. When the incumbent CEO stunts the development of potential successors.
iv. When the company is experiencing a period of rapid growth.
v. At a strategic inflection point.

In each case, investors and other stakeholders require sufficient information about a company's succession planning process to be able to determine the degree of business risk (or opportunity) present in the event of a change in CEO.

Currently disclosure on this subject tends to be restricted to a statement to the effect that a succession plan is in place. In our view this deprives interested parties the opportunity to make a fully informed qualitative judgement with respect to what can be a critical component of the future direction and performance of the company.

Health and safety and risk management

BP's recent experience in the Gulf of Mexico is a useful reminder that, to us, companies appear to pay more attention of health and safety, and risk management *outcomes* than they do to the quality of the business *processes* that underpin these.

That is, notwithstanding the Company's accident prone history, BP's recent experience before the Gulf of Mexico disaster in such drilling sites was not a useful indicator of the likelihood of an incident. Only analysis of the quality of the Company's health and safety, and risk management procedures could have alerted it and others to the likelihood of an adverse event.

In spite of this companies routinely disclose health and safety, and risk management outcomes without commenting on the quality of the business processes that underpin

[5] PricewaterhouseCoopers, Executive compensation: PWC FTSE 100 Review of the year 2007

[6] Knowledge@Wharton, *Job-less: Steve Jobs's Succession Plan Should Be a Top Priority for Apple*, http://knowledge.wharton.upenn.edu/article.cfm?articleid=2134

them (except for the usual boilerplate). We believe this risks the possibility that companies become complacent (for example, as outcome data improves even when processes are deteriorating), and deprives stakeholders of the opportunity to effectively police company behaviour in this regard.

Non-monetary rewards

The majority of executives studied by PricewaterhouseCoopers report they regard financial incentives as important but not necessarily of *critical* importance to business success.[7]

Indeed, most executives report being driven by *non-monetary rewards* including a sense of achievement, of being part of a successful management team, of working in a place where they are in tune with the organisation's values and objectives, and of building a great company.

These themes recur in most studies of employee motivation and engagement. It is widely acknowledged senior executives have their own motivation calculus, their own set of needs and desired results and that, to most, money is simply a form of calibration, or a way senior executives compare themselves with their peers – to 'keep score.'[8]

Equally, it has been found that the companies that most effectively motivate their employees to pursue future growth and concentrate on current performance take care to supplement financial rewards with unusually inclusive and motivating corporate cultures.[9]

At a company of this kind, employees see a close fit between its long-term interests and their own. Consequently, they are better motivated to work diligently and creatively to serve the business well. In such companies, the culture and incentive schemes serve to reinforce each other.

Nevertheless, we cannot think of a single instance in which a company has reported extensively on how it uses non-monetary reward systems to attract and retain staff, to motivate them to perform, or indeed to align their interests with the interests of shareholders by motivating them to deliver long-term business success.

We consider this a material omission in non-financial reporting which, if addressed, would significantly help stakeholders appraise the quality of a company's organisational capital.

5) In your opinion, for a EU measure on reporting of non-financial information to achieve materiality and comparability it should be based upon (check all relevant boxes):

- **Principles**
- **Key Performance Indicators (KPIs)**

[7] PricewaterhouseCoopers, *Out with the old: Creating a sustainable and effective approach to rewarding executives*, FTSE 100 – Review of the year 2008

[8] See, for example, Sandy Pepper, *Senior Executive Reward: Key Models and Practices*, Gower Publishing Ltd, 2006

[9] Jonathan D. Day, Paul Y. Mang, Ansgar Richter, and John Roberts, *Has pay for performance had its day?* McKinsey Quarterly 2002, Number 4

- Other

5a) In case you consider that Key Performance Indicators (KPIs) would be useful, would you think that they should be (check all relevant boxes):

- General for all economic sectors
- **Sector specific**

5b) Please indicate which indicators you would consider to be the most relevant for all economic sectors:

We consider the following indicators of greatest importance:
- Customer satisfaction
- Employee engagement
- Internal hire rate
- Absenteeism
- The quality of health and safety, and risk management processes
- Staff turnover
- Innovation outcomes and innovation capacity
- R&D productivity

6) In your opinion, what should be the process to identify relevant principles and/or indicators (whether general or sector-specific)?

In our experience successful companies choose key performance indicators on the basis of identifying cause and effect relationships they have established, and believe will hold, between the chosen indicator and strategic success.

In addition, they ensure the metrics are valid: i.e. they succeed in capturing what they are supposed to capture, and they ensure they are reliable: i.e. they reveal actual performance changes and do not introduce errors of their own [10]

Please explain. (In replying to this question, please comment on whether the Commission should endorse or make reference to any existing international frameworks (or a part of them), such as Global Reporting Initiative (GRI), UN Global Compact, the OECD Guidelines, ISO 26000, or other frameworks; or whether companies should be required to select relevant indicators together with their investors and other stakeholders and to disclose information according to such indicators, depending on the use that different stakeholders would make of such information).

In Kaplan's and Norton's experience many companies seem to have adopted boilerplate versions of non-financial measurement frameworks.[11]

[10] Robert S. Kaplan and David P. Norton, *Having Trouble with Your Strategy? Then Map It*, Harvard Business Review, September 2000, http://hbr.org/2000/09/having-trouble-with-your-strategy-then-map-it/ar/1
[11] Kaplan and Norton, op cit

If comprehensive reporting of non-financial KPIs is to be required this is not the outcome we desire. We want companies to find the performance indicators that support the execution and monitoring of their specific strategic plans.

Based on this position, we do not consider the Commission should endorse any particular framework. However referencing those that have an international basis, those that are process-based such as the AA 1000 stakeholder engagement standards and those that take a sector specific approach can provide some initial guidance on metrics that are of use to investors. In the latter category the GRI G3 Sustainability Reporting Guidelines can inform choice of metrics, and in so doing, increase the credibility, comparability, and utility of reporting efforts. A basic level of reporting to GRI is for companies to list which indicators are addressed in their reports as part of a "GRI Index." Such a GRI-based report also serves as a strong "Communication on Progress" for corporate signatories of the Global Compact.

7) In your opinion, should companies be required to disclose the steps they take to fulfill the corporate responsibility to respect human rights?

- **Yes**
- No
- No opinion

Please explain

LAPFF believes that by integrating human rights considerations into their mainstream business decision making, companies can safeguard reputation and brand image, gain competitive advantage, improve recruitment, retention and staff loyalty, foster greater productivity, secure and maintain a licence to operate, reduce cost burdens and ensure active stakeholder engagement. As such, disclosure of the company's strategy within this sphere would enable investors to determine whether potential human rights risks within their business are being appropriately captured and mitigated.

8) In your opinion, should companies be required to disclose the risks they face and the policies they have in the field of corruption and bribery?

- **Yes**
- No
- No opinion

Please explain

LAPFF supports the ICGN Statement and Guidance on Anti-Corruption Practices. The ICGN Statement and Guidance on Anti-Corruption Practices establishes the importance of combating bribery and corruption as part of the corporate governance agenda. LAPFF believes that bribery and corruption are incompatible with good governance and harmful to the creation of value. We also believe that investors have a responsibility to demand that companies have stringent policies and internal systems to avoid bribery and corruption. Specifically, companies need to ensure they demonstrate to their shareholders that they have appropriate systems in place to detect any corrupt payments, benefits or other actions and take appropriate preventative and enforcement measures to deal with corrupt activities.

9) In your opinion, what companies should be required to disclose non-financial information (check only one box)?

- Large listed companies
- Large companies (listed and non-listed)
- Medium-sized and Large listed companies
- Medium-sized and Large companies (listed and non-listed)
- **All listed companies (Small, Medium and Large)**
- None
- Other

In the Forum's view, there is substantial investor momentum for disclosure of information of this nature to be co-ordinated through national stock exchanges. In some European jurisdictions there are specific mandated ESG disclosure requirements. In others, guidance is provided relating to specific ESG issues. For example the Forum has set out that it considers the UK government should make corporate reporting on greenhouse gas emissions mandatory by integrating a standard into the narrative reporting guidance for the Business review and in the UK stock exchange listing requirements.[12] The Forum considers that a large number of companies are still not addressing the risks posed by climate change, nor indeed the opportunities presented, and that investors would be better served by fuller reporting on this issue. In the US, the SEC issued interpretive guidance in 2010 on disclosure related to business or legal developments regarding climate change.

Thus stock exchanges globally can determine or influence the utility of company disclosure, and are key to providing the level of consistency and comparability of ESG reporting necessary for investors to be able to integrate such factors into their overall investment analysis.

10) In your opinion, should institutional investors be subject to specific or additional disclosure requirements, for example to disclose whether and how they take into account environmental and social issues in their investment decisions?

- **Yes**
- No
- No opinion

Please explain. (In replying to this question, please provide information on which issues seem to be the most relevant and why; and which institutional investors should be subject to such an obligation).

Contrary to opinion held in some quarters, sophisticated valuation analysis is widespread in the investment industry. Where firm value is more dependent on accounting

[12] http://www.lapfforum.org/pubs/press_releases/PressReleaseclimatechangeTP050707.pdf

intangibles, for example, the sell side research consumed by institutional investors normally gives greater weight and attention to information about non-financial performance such as firm strategy, managerial competence, and R&D expenditures.[13]

Nevertheless, research into the way in which analysts incorporate business forecasts into stock recommendations supports the notion that investors focus primarily on a narrow set of indicators of financial performance.

Analysts have learned to pay most attention to information that is both salient and recent. They are drawn to using information that appears more concrete, that is easier to absorb and integrate into their analysis, and which they consider to be more trustworthy. Indeed, these are all reasons sceptical analysts cite for *not* incorporating non-financial information in their work.

In our view this disconnect between the factors analysts and fund managers anaylse and the factors that get reflected in investment decisions is not resolved by the increasing number of investment institutions that claim to integrate consideration of ESG factors in their investment decisions.

Outside a minority of institutions in which the consideration of non-financial information is ‘baked into’ investment processes, our experience suggests a gap exists between the capability of most dedicated ESG analysts (a) to gather ESG data relevant to investment decisions and (b) to persuade their internal fund managers of its relevance.

In our opinion, this often leaves even those institutions that claim to take an integrated approach paying lip service to this principle.

We believe a specific requirement to evidence integration in action within and across portfolios and asset classes would help remedy this situation.

11) In your opinion, should European policy promote the concept of "integrated reporting"? (Integrated reporting refers to a report that integrates the company's key financial and non-financial information to show the relationship between financial and non-financial performance (environmental, social, and governance).

- **Yes**
- No
- No opinion

Please explain. (In replying to this question, please indicate the advantages and disadvantages of an integrated report, as well as possible specific costs of integrated reporting).

It appears to us an integrated report is the most appropriate (possibly the only) place a company can hope to convey an understanding of how it combines physical and

[13] James O’Loughlin and Raj Thamotheram, *Enhanced Analytics for a New Generation of Investor: How The Investment Industry Can Use Extra-Financial Factors in Investing*, Universities Superannuation Scheme Ltd

intangible resources into processes and practices that provide the organisational capital that sets one company apart from another.

12) In your opinion, should disclosed non-financial information be audited by external auditors?

- Yes
- **No**
- No opinion

Please explain. (In replying to this question please provide any evidence you may have regarding costs of auditing non-financial information, as well as your views on other possible forms of independent reviews besides external auditing).

Stakeholder appetite for more and better disclosure of non-financial information clearly makes a call on the resources of the disclosing company. In our opinion, a careful balance needs to be held between calling for additional disclosure that enhances capital allocation within the financial system and calling for disclosure that merely adds cost to the financial system.

We believe there is value to be had from enhanced disclosure of non-financial information. (For example, Baruch Lev cites several examples of companies and sectors in which poor disclosure has led to undervaluation – with consequent cost of capital and capital allocation effects). However, we would stop short of adding the extra layer of expense that would come with a requirement for external auditing. In our view, the market will be the final arbiter of whether disclosed non-financial information is sound or not.

13) If you have relevant documents you want to share with us, please attach them here.
Intention to submit the Forum's feedback to the UK BIS consultation on narrative reporting, October 2010.