Environmental, Social and Governance (ESG) and Integrated Reporting

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Abstract Corporate Social Responsibility (CSR) and sustainable development address the relationship between business and society. In the 1980s, the Brundtland Report by the World Commission on Environment and Development (WCED, Our common future (Burdtland Report). Retrieved from https://sustainabledevelopment.un.org/content/documents/5987our-common-future.pdf, 1987) coined the term sustainable development and its principle of sustainability for economic prosperity. These were reinforced by the United Nations (UN) 2030 Agenda for Sustainable Development, the blueprint for a more sustainable future. In parallel, CSR has received increased attention in practice and in theory, and has been defined by the European Commission as “the responsibility of enterprises for their impacts on society” (A renewed European Union Strategy 2011–2014 for Corporate Social Responsibility, 2011, p. 6). Calls for CSR have been framed through a mix of voluntary and law mandated corporate actions which have led to conflicting results. In a twenty-first century bedevilled by challenges and macro systems’ disruptions (e. g. social institutions, natural resources and technologies), environmental, social and governance (ESG) factors represent risks and opportunities that are strategically relevant and increasingly inform how businesses are run and investment decisions made. To reach their full potential, ESG need to be measured, included in managerial and investment decision-making and accounted for in integrated reporting.

1 Introduction

Demands on corporations (and their investors) to address societal expectations are on the rise and represent a key aspect of the contemporary business landscape. Global initiatives such as the UN Global Compact (UN 2020) and multiple OECD guidelines (OECD 2011a, 2011b, 2015, 2018) aim to encourage and guide corporate
and investment behaviour. Although it is beyond the scope of this chapter to elaborate on the heterogeneity of investor types and their short or long term investment horizons, it is critical to note that if corporations are to become socially responsible and create sustainable value, they need, among others, the support of their investors, their capital providers. Since the late 1980s (Avetisyan and Hockerts 2017), ESG encapsulate environmental (contribution to the climate transition or circular design of products and services), social (community impact, inclusion or combating modern slavery) and governance (executive compensation, disclosure, short and long term financial health of a company) dimensions of business strategies. ESG remain difficult to measure (Brest et al. 2018), yet represent an opportunity for standardization in the field of sustainable value creation (Avetisyan and Hockerts 2017).

Studies have investigated a range of issues surrounding CSR and sustainable development: these include managerial perceptions of social responsibility (Bansal et al. 2014; Singhapakdi et al. 1996), the importance of social responsibility in managerial decisions (Vitell and Paolillo 2004), executive perceptions of CSR (Skouloudis et al. 2015), external factors affecting socially responsible decision-making (Vashchenko 2017), the effect of managerial perceptions of ethics and morals on sustainable value creation (Wang et al. 2018), and managerial motivation for social and environmental disclosures (Jackson et al. 2020; Shafer and Lucianetti 2018). One of the key insights across these studies is that companies face increasing societal pressures. CSR and sustainable development remain difficult to measure and to incorporate in business decisions. In parallel, while earlier studies questioned the relevance of ESG (Campbell and Slack 2011; Deegan and Rankin 1997), more recently these factors have been shown to relate to significant economic and financial effects (Dhaliwal et al. 2011; Cheng et al. 2014; Grewal et al. 2019; Khan et al. 2016). ESG consideration varies from merely superficial interest to ESG forming a cornerstone of investment and business decisions (Kiernan 2007; Neri 2019; Vasuveda et al. 2018).

The path to socially responsible corporate behaviour remains bedevilled by tensions. Fundamentally, it is legitimate and reasonable both for society to expect corporations to contribute to sustainable development, and for investors to maximise the value of the assets entrusted in their care, and corporations need, among other things, to be financially healthy in order to remain in business. However, how these expectations and needs can be reconciled is a matter filled with tensions.

Many companies and investors “remain ambiguous about what it means to be socially responsible” (Neri et al. 2019, p. 442). ESG factors can act as indicators of risks and opportunities that may affect the financial bottom line (Van Duuren et al. 2016) and the ability to create value (Neri 2020b), thus they encapsulate a potential contribution to sustainable development. For instance, they can point to upcoming regulation (as was the case in the 2016 Facebook Cambridge Analytica scandal which accelerated the European General Data Protection Regulation) or they can be instrumental in shifting consumer preferences (e.g. towards healthier food and lifestyles), or affect a corporation’s ability “to produce people” (Hollensbe et al. 2014, p. 1229), in other words committed and dedicated employees.
Against this backdrop, this chapter focuses on the lack of globally accepted ESG standards of measurement and the resulting lack of integrated reporting. This chapter will proceed as follows: first, it elaborates why it is critical for companies and investors to be able to measure the potential and real impact of ESG risks and opportunities; second, it presents the challenges that a lack of integrated reporting poses to responsible corporate behaviour.

2 ESG Risks and Opportunities

Crises have a tendency to accelerate trends. The turmoils of 2020, from the climate emergency and the global pandemic to the racial justice movement have propelled ESG into the mainstream conversation on CSR and sustainable development (Mooney 2020). ESG have emerged as strategically relevant and important because they represent many of the externalities around us (Neri 2020a; Powell 2020), encapsulating material risks and opportunities for companies and their investors (Espahbodi et al. 2019; Van Duuren et al. 2016). ESG represent “a tragedy (…) and a golden opportunity for positive system change” (Kiernan 2007, p. 478), as they boil down to what can make or break the very existence of a business.

“Society has reached its planetary limits for growth” (Bansal 2019). The world seems to be waking up and the ESG tide appears to be shifting (Goyer and Jung 2011; Semenova and Hassel 2019). The “bandwagon is rolling” (Cornell 2020) and ESG have been called the acid test of responsible capitalism (Powell 2020) and the new corporate Zeitgeist (Nauman 2020). Business is under extreme pressure to act upon its social responsibility and contribute solutions to the challenges of our time. Responsible business is no longer a distant chimera: it is a real and pressing business matter. As Kathleen McLaughlin, Walmart’s Chief of Sustainability stated: “You can’t separate environmental, social and economic success” (Financial Times 2020). Given the importance for companies to understand, account and report on ESG, it is both surprising and worrying that to date globally accepted ESG standards of measurement are missing and that the so-called “integrated reporting” is, in fact, not integrated at all. Furthermore, ESG factors continue to be referred to as non-financial and, when at all, accounted for in non-financial statements, most often separately from financial reports.

ESG isn’t a new concept. The acronym dates back to the 1980s (Avetisyan and Hockerts 2017; Neri 2020b) but the underlying ideas are as old as humanity. Throughout history, nature has been disruptive, yet the climate crisis is accelerating the urgency of tackling environmental problems. Social unrest has also always existed, whether in ancient Greece due to wealth and land inequality (Fuks 1984), in the city of Norwich in Tudor England following disastrous harvests (Hoskins 1964), in Somalia, Rwanda and the former Yugoslavia following poverty and unemployment in “the lost decade of the 1980s” (Chossudovsky 1997, p. 1786), or in Hong Kong in the summer of 2019 (Korner 2019). Corporate governance issues (and scandals) are also not new, as the failings of the Italian Medici Bank in 1494.
indicate (Dinesen 2020), with regulation aimed at improving governance effectiveness and strengthening control. What is different now is the immediacy, the scale and the global effects of the consequences of such events, giving added urgency and importance to responding and anticipating them, hence the increasing centrality of ESG factors in business and investment decisions. What is also different now is that companies’ main sources of value have increasingly shifted from tangible to intangible assets (Hanson 2013; Haskel and Westlake 2018), however current financial standards and accounting practices were created at a time when tangible assets dominated value creation. Consequently, there is a need for urgent adjustment.

Some management scholars and practitioners argue that there is a risk that companies and their investors pay lip service to ESG adoption (Armstrong 2020; World Economic Forum 2019), “claiming to be socially responsible” (Reghunandan and Rajgopal 2020, p. 1). In other words, there is a risk of facing “incidences where an organization's ‘talk’ does not match its ‘walk’ ” (Glozer and Morsing 2020, p. 363). However, there is also a promise that a mainstream adoption of ESG standards might enable financial reporting that accounts for the risks and opportunities intrinsic to all aspects of contemporary business, thus helping corporations to create sustainable value rather than paying lip service to it. This promise needs to be appreciated within the current context.

The twenty-first century features scholars, business leaders, investors and policy makers’ calls for responsible capitalism (Mayer 2016, 2017; Mayer et al. 2017; Starbuck 2014), shareholder and stakeholder activism, the rise of social media (Joe et al. 2009; Liu and McConnell 2013) and a pervasive crisis of trust towards business (Edelmann 2020; Starbuck 2005). Climate change, social tensions and unrest, and governance issues pose real threats to companies but also represent opportunities for innovation, new products, new lines of business or business models, therefore these factors are relevant to companies (The Economist 2019a, b). Consequently, it can be expected that if corporations are to create sustainable value they need to be able to measure, decide upon and account for ESG factors that are material to their businesses. They need to do so because these factors encapsulate the contemporary business conditions for sustainable value creation.

ESG are prompting a corporate realization that value creation can only be achieved sustainably, in other words along environmental, social, financial and governance dimensions which exist both in the short and long term. The following examples illustrates how critical both the short and long dimensions of ESG factors are. In October 2018 Patisserie Valerie, a listed UK coffee chain, went into administration. The case revealed serious governance issues, while the company had been scrutinised for its sourcing of palm oil, in common with similar businesses. Long-term thinking had pushed Patisserie Valerie’s investors and leaders to investigate the palm oil sources for its finest cakes and eclairs, without noticing that the business was close to bankruptcy (Financial Times 2019a; Montagnon 2019). The second example relates to the coronavirus pandemic upending the world economy in 2020. Since the beginning of this crisis, a growing list of companies from Rolls-Royce to Disney, Electrolux and H&M have slashed dividend payouts. Most importantly, some investors are not convinced that the measure is temporary or short-term
The pandemic seems to have accelerated a significant shift in how companies dispose of their free cash flow, following increasing acceptance that they bear a responsibility towards all stakeholders (including investors) and the wider society. The above examples indicate how critical it is for businesses to attend to both short and long term dimensions of ESG if they are to “sustain” and create value next quarter as well as in the next 20, 40 or 100 years. Although there is a tendency to think of social responsibility, ESG and sustainability in terms of a distant future, their integration in business decisions needs to take the form of a “pattern of converging decisions” (Gray and Ariss 1985, p. 707), in other words an organized whole of “short-term steps for long-term change” (Kemp et al. 2007, p. 315). These steps are to be measured and reported upon, so that they can be fully integrated in decision making and corporate reporting, a matter that remains filled with tensions.

3 Integrated Reporting

Historically, the concept of measuring and reporting the social, environmental and economic impact of a corporation was popularized in the late 1990s and early 2000s, partly due to John Elkington’s (1997) book Cannibals with Forks: The Triple Bottom Line of 21st Century Business. Elkington’s work is credited with starting new, non-financial reporting frameworks from an environmental and social point of view (Dumay et al. 2016; Gray 2006).

Integrated reporting is a framework of reporting where non-financial and financial information are considered jointly, allowing companies to better detect risks and opportunities not only retrospectively, but also before they arise. In this way, ESG can provide managers, investors and other stakeholders (i.e. employees, customers and policy makers) comprehensive insights into how a business operates and its financial, social and environmental impact, including how sustainable the business is or is becoming. Integrated reporting requires globally accepted ESG standards of measurement and reporting, as is the case for the current financial standards and accounting practices. The meaning of integration is quite different from the current understanding, where integration refers to the inclusion of non-financial reporting in a company’s annual report. According to the EU Non-financial Reporting Directive II (EU 2014) which came into effect in 2018, and the succeeding Non-binding Guidelines (EU 2017), environmental, social and governance matters are to be reported separately from, or in separate sections of, financial statements, rather than fully integrated (i.e. accounted for in the figures) into the same financial reports.

Since the 1980s, a plethora of ESG rating agencies have emerged (Avetisyan and Hockerts 2017; Brest et al. 2018), mainly focussed on retrospective ratings, examples of which include Morningstar, B Analytics, TSE4Good and the Dow Jones Sustainability Index. A variety of cross-industry initiatives on ESG reporting also exist, and include the Global Reporting Initiative, the Financial Stability Board Task Force on Climate Related Financial Disclosures, and the Sustainability Accounting
Standards Board. Corporations also face a multitude of single-issue niche groups, and 230 ESG standards for over 80 industry sectors in 180 countries (Solvang 2018). These represent several competing sets of standards by which to measure and report ESG. Furthermore, a common preference to categorise ESG as non-financial shapes the current policy debate on integrated reporting as a “1+1” discussion, promoting the illusion that these factors are anything other than financial. Consequently, recent developments in integrated reporting (EU 2014, 2017) contribute to relegate ESG to non-financial business dimensions and represent a tension corporations and their capital providers face in delivering sustainable value. How can a business be socially responsible if it cannot understand and measure the threats, opportunities and effects of climate change and incorporate them in its quarterly reporting, profit & loss statement or balance sheet, as a first step to contribute solutions to the climate crisis? After the 2019–2020 ravaging fires in California or Australia, how can corporations with facilities and operations in those areas account for their tangible and intangible losses and future exposure? How can corporations anticipate the social effect of the global pandemic on their employees or the effect of social unrest on their retail distribution and brand image? These are questions that global ESG standards and truly integrated reporting could contribute to address.

The multitude of non-globally accepted ESG standards, coupled with a myopic regard on ESG as non-core factors, impair a comprehensive consideration of their related risks and opportunities. This status quo also reinforces views of these factors as having little to no impact on the bottom-line (Klasa 2018; Van Duuren et al. 2016). The EU-recently mandated integrated reporting (in force since June 2019) (EU 2014, 2017), and the US Congress rejection of the adoption of ESG standards (Temple-West 2019) offer institutional support for views of value creation which are divorced from reality. They also represent a critical tension impairing the institutionalization of the corporate contribution to sustainable development. Through institutionalisation, CSR and sustainable development can become embedded in the social structure (Li 2017; Zucker 1977), in other words they can reach a point where nobody would dream of questioning what they are and why they matter, and therefore why ESG need to be integrated in decision-making and reported on.

In its current form, financial reporting is in itself a tool no longer fit for purpose. Financial reporting and accounting standards, as well as the network of professionals supporting them, developed from humble beginnings in the fifteenth century (Financial Times 2019b). In the twenty-first century, sources of, and impact on, value creation can take the shape of human, social or natural capital: hence, there is a need to go beyond a financial view of how a business is doing. ESG standardisation is an enabler of integrated reporting and it demands patience. Despite the current lack of global standards, recently mandated ESG disclosure (EU 2014, 2017) is an important, first step forward, but in its current form it is not enough to support the integration of ESG in business and investment decisions.

Although it has taken more than four hundred years to arrive at contemporary financial standards and accounting practices, the magnitude and urgency of the challenges of our time require immediate attention to make integrated reporting truly integrated, with “non-financial” factors regarded as financial and accounted for in numbers within financial reports. Society, policy makers, companies and their
investors can ill-afford to wait another four hundred years for a globally accepted integrated reporting framework to emerge.

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