THE LONG VIEW

Raising the Standard: The Challenges and Value of Sustainability Reporting

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Skerryvore

'It took me a surprisingly long time to embrace the idea that accountants hold the key to saving civilization'

Rebecca Henderson, *Reimagining Capitalism in a World on Fire* (2020)[1]

The explosion of environmental, social and governance (ESG)-related data sometimes leaves us sitting with our heads in our hands. For example, we have seen company annual reports swell from close to 100 pages in 2010 to nearly 500 last year. Not all this growth is because of ESG content but the growing interest in ESG has contributed to the swelling of a large number of annual reports with information that isn't always terribly useful. Alongside this, all the major data providers are now selling proprietary ESG data sets and providing sustainability rankings that are wildly inconsistent.

It's not that we think ESG information is irrelevant or valueless. Quite the contrary; it can be very useful. But it is difficult to make it user-friendly. However, reading Rebecca Henderson's excellent book *Reimagining Capitalism* reminded us that accounting standards also used to be a mess. Their story gives us hope for the future of sustainability data. We understand that it takes a special kind of person to love standards but, if you bear with us, we'll try and explain why the right kind of sustainability reporting really matters.

THE HISTORY OF STANDARDS

Accounting standards emerged out of the crisis that was the Great Depression.[2] Before that companies could report however they wished, which explains the 200-word P&G report of 1919 and Unilever's 15-page annual report of 1929 that does even not include total sales.

The US Securities and Exchange Commission (SEC) and the United States Generally Accepted Accounting Principles (US GAAP) came from that and have led ultimately to the thoughtful and comprehensive disclosure we see in financial statements today.[2,3]

This was achieved through the rise of standards bodies, and although there are several different versions today (GAAP, Indian GAAP – a topic for another day, and IFRS) there is broad agreement on what should be disclosed and how, as well as consequences for non-compliance. This gives us the ability to look across a broad spectrum of businesses operating in different jurisdictions and compare their financial performance. IFRS (International Financial Reporting Standards), for example, has been accepted across more than 140 countries.[4]

Where the world is moving to, however, is a realisation that accounting standards don't seem to account for a planet that is becoming hotter, growing inequality, declining biodiversity or simply the fact that our current path of progress does not look sustainable. Capitalism of the future needs to understand the real cost of doing business and the consequences of the sale of products or services. Nature may abhor a vacuum, but data providers might beg to differ. This has resulted in a proliferation of proprietary standards and data sets as a scramble begins to try and own ESG data. But a world where the data many stakeholders need to make informed decisions is hidden behind paywalls doesn't seem to us to be the solution.

One concern we have with some sustainability reporting is it enables companies to deflect from material issues. For example, many businesses now report on progress towards the United Nation's Sustainable Development Goals, which comprise a set of aspirational outcomes that even the hardest-hearted capitalist would struggle to deny. The challenge with these is that companies can choose what to report, so the informational content in what is disclosed is very low and the materiality suspect.

A company we looked at recently even claimed to contribute to reducing world poverty by paying salaries… This may be true, but it is not helpful in distinguishing between good and bad companies.

WHAT MAKES A GOOD SET OF STANDARDS?

Good standards need to be **decision-useful, material, comparable and cost-effective** to report on. Having a good set of standards will allow us to distinguish between sustainable leaders and laggards, measure progress over time and hold management and owners to account.

At this point we would like to introduce Jean Rogers, an engineer by training and a champion of standards. In 2011, she founded SASB (*saz-BEE*; the Sustainable Accounting Standards Board), which she led for seven years. The thinking behind this was the very definition of a good standard and was driven by a focus on materiality, or measuring what matters. To do this well requires an industry-based approach. The carbon emitted by a cement company or an airline matters. The carbon emitted by a chain of pharmacies is not so material, but its patient outcomes are.

SASB has created a detailed set of disclosures by industry (77 currently) that focus on the things that make a material difference to the long-term value of a business, tempered by a focus on the pragmatic – i.e. cost-effectiveness. In many instances the data is already being recorded by companies – it just isn't being published in a standardised format.

We were encouraged in a recent conversation with a South African pharmacy we own on behalf of a client regarding SASB. Although the company doesn't currently report according to the standard, they were excited by the prospect of something that focused on materiality. They already measure patients' health outcomes, one of the material facts required by SASB, and believe they have a genuine advantage in this area. This example highlights that the best companies are likely to gain an advantage as material data becomes more widely available thanks to their sustainable positioning. The best companies should attract capital at a lower cost and ultimately, we believe, be preferred by customers. Greater transparency should help the kinds of companies we like to own.

THE CHALLENGE NOW IS ADOPTION

Although the good companies will embrace this standard, weaker ones will not. Some progress has been made, with around half of the S&P 1200 now disclosing according to SASB's standards and around one quarter of the companies we hold.[5] There is still a considerable way to go.

It was in this context that we were, if we may use the word, excited by the announcement that a number of sustainability reporting organisations are coming together to form the ISSB (International Sustainability Standards Board), including SASB.[6] This organisation will sit alongside the IASB (International Accounting Standards Board), which is responsible for IFRS, the near-global accounting standard referred to earlier. This development puts the work behind SASB into a position where it is likely to evolve into globally accepted sustainability disclosure standards.

The path may not be an easy one: There are a lot of vested interests that will not want to publicise their poor performance and data providers that would rather keep information proprietary.

It's not just about the figures: Even if the standard becomes global it may suffer from some of the same issues that accounting standards do. The Coke System, which comprises a number of family-owned bottling companies around the world, is a good example. They already report data according to SASB but the energy per litre sold consumed by Coke Hellenic is not directly comparable to that used by its peer Coca-Cola Euro pacific Partners because of the different countries that they operate in.[7,8] As with accounting data, it will remain important to understand the why and the how, rather than simply the what.

CONCLUSIONS

Hopefully, if you've made it this far, you'll be feeling, like us, a little more optimistic about the future of disclosure of the kind of data that will allow us to make more informed decisions based on long-term sustainability considerations. We have always believed that the long-term financial outcome of a business relies on it behaving sustainably and that the best businesses will create advantage for themselves by positioning themselves ahead of expectations and exploiting the benefits of the positive reputation this creates. It is likely, we believe, that increased transparency will help the type of companies we own because this kind of advantage translates into the way companies are valued. Finally, for companies that are not behaving sustainably there will be a strong incentive to improve, which can only be good for all of us in the long-term.

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4. IFRS Foundation (2021). Who we are. **www.ifrs.org/about-us/who-we-are/#history**
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8. Coca-Cola European Partners (2019). 2019 SASB Index.

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