The Challenge and Opportunity of Sustainability Reporting—Part 1

By Frank Grossman

The subject of this extended article is a new and emerging counterpoint to financial reporting, namely sustainability reporting. The first portion of the article, describing the advent and recent evolution of sustainability reporting, as well as its relevance to actuaries, is set out below. Its second and concluding installment is forthcoming, and will deal with the way forward for sustainability reporting, as well as the opportunity it presents for insurance companies.

1. THINGS NOT TRADITIONALLY TAKEN INTO ACCOUNT

Financial actuaries worth their salt have a keen appreciation of how well financial accounting standards support the various accounting principles. Proper recognition of income and expenses can be a challenge for life insurance products, due to their intricacy and inherent risk-transforming nature. The myriad complexities of accounting for acquisition costs, flexible as opposed to scheduled premiums, and embedded options—whether hedged or not—will doubtless be familiar to many readers.

One accounting principle is often completely taken for granted. This is the requirement that only events or transactions that can be expressed in monetary terms be reported. And yet, the financial consequences of certain events can be difficult to quantify, at least in the near term. Particular examples include the resolution of a key management disagreement, development of a new product or sales concept, and the loss of intellectual capital due to staff turnover. It's possible that details about these types of events may be located in footnotes to the financial statements, but by and large they are "externalities," or things not otherwise taken into account.

Taking a broader perspective, there has been growing public awareness of a number of social and environmental issues in recent years, not only at home but around the world. These issues include the apparent threats posed by communicable diseases such as HIV/AIDS, climate change, lax labor standards, obesity, and the degradation of our environment. Greater awareness has led to an unprecedented level of scrutiny of firms, including those in the insurance industry, and the sustainability of their business practices. However, the economic consequences of such issues are generally not included in traditional financials, and the risk is that they too are deemed to be externalities by management teams.

2. EMERGING FRAMEWORKS

In response to growing interest, there has been a significant increase in the voluntary disclosure of non-financial information by firms. Initially done on an ad hoc manner beginning in the late 1990s, these disclosures have achieved greater consistency and breadth over the intervening years, due in large part to the emergence of several reporting frameworks.

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The United Nations (UN) Global Compact is the largest voluntary corporate responsibility initiative in the world with over 12,000 corporate participants in more than 145 countries. Launched in 2000, the UN Global Compact encourages firms to align their operations and strategies with 10 universally accepted human rights, labor, environment and anti-corruption principles.

- Human Rights (principles 1-2)—Businesses should support and respect the protection of internationally proclaimed human rights; and make sure that they are not complicit in human rights abuses.
- Labor (principles 3-6)—Businesses should uphold the freedom of association and the effective recognition of the right to collective bargaining; the elimination of all forms of forced and compulsory labor; the effective abolition of child labor; and the elimination of discrimination in respect of employment and occupation.
- Environment (principles 7-9)—Businesses should support a precautionary approach to environmental challenges; undertake initiatives to promote greater environmental responsibility; and encourage the development and diffusion of environmentally friendly technologies.
- Anti-Corruption (principle 10)—Businesses should work against corruption in all its forms, including extortion and bribery.

An international coalition of investors and non-governmental organizations (NGOs), Ceres, in collaboration with the Tellus Institute and with the support of UN Environment Program (UNEP) launched the Global Reporting Initiative (GRI) in 1997. Their shared challenge was to develop a standardized approach from the several competing sustainability reporting visions. Today the GRI is based in Amsterdam, and more than 2,500 firms worldwide use its framework to voluntarily inform their stakeholders about how they are integrating sustainability into their operations.

More recently, at the 2012 UN Conference on Sustainable Development held in Rio de Janeiro (aka Rio+20), a set of four Principles for Sustainable Insurance (PSI) was launched with the support of the UNEP's Finance Initiative and 27 insurance company signatories. The four principles are as follows:

1. We (the insurance companies) will embed in our decision-making environmental, social and governance issues relevant to our insurance business.
2. We will work together with our clients and business partners to raise awareness of environmental, social and governance issues, manage risk and develop scenarios.
3. We will work together with governments, regulators and other key stakeholders to promote widespread action across society on environmental, social and governance issues.
4. We will demonstrate accountability and transparency in regularly disclosing publicly our progress in implementing the principles.

Though there are 42 PSI signatory companies today, only one is domiciled in either the United States or Canada: the Co-operators Group, based in Guelph, Ontario.

3. SIMILAR BUT DIFFERENT

In practice, corporate responsibility reporting can often be reactive, responding to public relations crises and adopting a defensive stance. Some firms focus narrowly on issues such as the cost of limiting their greenhouse gas emissions. Too often, the linkage between vague statements and circumscribed data disclosures that comprise some corporate responsibility reports on one hand, and management's strategic goals and the viability of its underlying business model on the other, may be weak or absent.

Sustainability reporting, by comparison, describes sustainability objectives and relates progress toward achieving those goals. It strives to augment traditional financial reporting by delivering an unvarnished and comprehensive self-assessment of the environmental, social and governance (ESG) issues that affect the firm and its stakeholders. Figuratively speaking, sustainability reporting succeeds by getting the firm's externalities on the table for all to see.

The foregoing might prompt one to ask: What is sustainability? The adjective "sustainable" means something that can be maintained over time. Twenty-five years ago, the UN World Commission on Environment and Development defined "sustainable development" as development that "meets the needs of the present generation without compromising the ability of future generations to meet their own needs." Hence, a sustainable business strategy, which resides at the core of sustainability reporting, is one that paves the way for success over the long run—a time frame that seems only natural to most actuaries.

4. THINKING CAPS ON

Sustainability reporting may seem like a complex, unstructured problem to many, and its resource requirements should not be underestimated. Identifying or creating reliable data across one's organization can be an obstacle, particularly for multinationals operating in different jurisdictions or industries. Developing key performance indicators that make sense is an ongoing challenge. And, delivering a single integrated report is becoming the new norm. Even though sustainability reporting frameworks offer much-needed structure and promote comparability, they may lack the flexibility needed to capture the circumstances and issues confronting individual firms.

Insurance company issues typically addressed by sustainability reporting often reside in the catch-all category of operational risk—for example: regulatory concerns about product suitability; technological safeguards associated with data security and privacy concerns; physical risks to plant and staff posed by extreme weather events and inundation; and resource issues like energy costs and the development and retention of human capital. Firms may understandably struggle to gain a thorough appreciation of how sustainability issues affect their entire value creation chain, from suppliers through to clients and their beneficiaries.

Common examples, such as installing solar panels on the head office roof, and taking steps to improve energy efficiency, may appear to be good news all around. However, providing free parking for staff, and indirectly promoting personal vehicle use, may present quite a different sustainability story. And the real-world complexity of sustainability reporting doesn't end there.

> "…sustainable development…meets the needs of the present generation without compromising the ability of future generations to meet their own needs."

How sustainable is a product development strategy that sails too close to the wind when interpreting relevant statutes and supervisory guidelines in an attempt to win market share? In another real-world example, U.S.-based companies are increasingly transferring back office functions to low-cost countries where labor markets and environmental conditions are more lightly regulated. Just how does one begin to assess the hidden social and environmental costs of outsourcing, including the elimination of jobs closer to home?

5. SHAREHOLDER VERSUS STAKEHOLDER VALUES

At one point, the basic question arises: What should be the purpose or goal of a firm? This question can obviously trigger a wide range of strongly held opinions. One familiar answer is that a firm should exist solely to make money for its shareholders. Support for this view can be traced back through Milton Friedman all the way to Adam Smith and his view that most companies do good simply as a byproduct of their pursuit of profits—that private profit is a public virtue. And, by extension, Friedman held that the firm's only responsibility to non-shareholders is that which is required by the law.

Alternatively, supporters of a stakeholder theory of the firm, first articulated by Edward Freeman in the early 1980s, believe that the firm must balance the needs of all stakeholders, and this means any group affected by the activities of the firm. Stakeholders include not only shareholders, but the firm's employees, customers, suppliers and the government, as well as the commu-

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Table 1: GRI Sustainability Disclosure Database—Number of Reports Filed*

	2008			2013			2008 to 2013 Increase		
	Financial Services	Other	Total	Financial Services	Other	Total	Financial Services	Other	Total
Northern America†	20	140	160	59	536	595	195%	283%	272%
Europe	95	432	527	181	1,168	1,349	91%	170%	156%
Other	56	449	505	249	1,639	1,888	345%	265%	274%
Total	171	1,021	1,192	489	3,343	3,832	186%	227%	221%

*Note that not all reports included in GRI database are compliant with the most recent GRI Guidelines.
†Northern America (sic) excludes Latin America and the Caribbean.

nity in which the firm is physically located. Because sustainability reporting transcends financial reporting's focus on net income, it speaks to those who may not be investors, and yet are deeply invested in the ongoing success of the firm. And these external stakeholders are increasingly asking tough questions, pointing out strategic options, monitoring progress and holding management accountable. The challenge of responding effectively to these diverse audiences may seem overwhelming, and yet doing so is essential to long-run sustainable wealth creation.

6. GAINING TRACTION

The emergence of a standard framework for sustainability reporting, namely the GRI mentioned previously, has facilitated its adoption by firms, both across industry sectors and around the globe. Over their short history, the GRI Sustainability Reporting Guidelines have evolved, and become more stringent. The most recent fourth release (G4) aims to "help reporters prepare sustainability reports that matter, [and] contain valuable information about the organization's most critical sustainability-related issues."

The Corporate Sustainability Reporting Coalition (CSRC), spearheaded by U.K.-based insurer Aviva, representing financial institutions, professional bodies, NGOs and investors with US$2 trillion of assets under management, sought greater disclosure of ESG performance via a global Convention on Corporate Sustainability Reporting presented at Rio+20. Despite the horse-trading typically encountered when drafting a UN conference communiqué, there was partial acceptance of the CSRC's policy proposal. In particular, its call for greater integration of sustainability issues within the annual reports of all listed and large private companies is reflected in Point 47 of "The Future We Want" agreement:

We (the UN member states) acknowledge the importance of corporate sustainability reporting and encourage companies, where appropriate, especially publicly listed and large companies, to consider integrating sustainability information into their reporting cycle. We encourage industry, interested governments and relevant stakeholders with the support of the United Nations system, as appropriate, to develop models for best practice and facilitate action for the integration of sustainability reporting, taking into account experiences from already existing frameworks and paying particular attention to the needs of developing countries, including for capacity-building.

A second core element of the CSRC proposal advocated for sustainability reporting on a "report or explain" basis, and this was not taken on board at the conference. "Report or explain" means that firms may elect not to report on sustainability issues, but they would have to explain their reasons for opting-out to their stakeholders. Essentially, this was a continuation of the voluntary approach to sustainability reporting, but required a good reason—or at least a plausible excuse—for noncompliance.

7. EVER-PRESENT PITFALL

Maybe it's not so surprising, in an age of widespread disbelief, that skepticism about corporate progress on the environmental front has generated a new dictionary definition. The term is "greenwash," which is defined as "misleading information disseminated by an organization so as to present an environmentally responsible public image." Clearly, there is some particular need for firms to avoid the temptation to burnish their green credentials by overstating ESG results, and thereby risk having their sustainability reports dismissed as just another greenwashing effort. On reflection, sustainability reporting seems to necessitate adherence to another age-old accounting principle in order to be wholly credible—the principle of conservatism. ■