THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

29 May 2009

Our ref: ICAEW Rep 46/09

Lloyds Banking Group
25 Gresham Street,
London
EC2V 7HN

By email: John.Swannick@LloydsTSB.co.uk

Dear John

VALUING NON-FINANCIAL PERFORMANCE: A EUROPEAN FRAMEWORK FOR COMPANY AND INVESTOR DIALOGUE

The Institute of Chartered Accountants in England and Wales (ICAEW) is pleased to respond to the request from the European Alliance for CSR for comments on *Valuing non-financial performance: A European framework for company and investor dialogue.*

Please contact me should you wish to discuss any of the points raised in the attached response.

Yours faithfully

Rachel, Bird
Sustainability Manager, ICAEW
T +44 (0)20 7920 8794
F +44 (0)20 7638 6009
E rachel.bird@icaew.com

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN ENGLAND AND WALES

ICAEW Representation

ICAEW REP 46/09

VALUING NON-FINANCIAL PERFORMANCE: A EUROPEAN FRAMEWORK FOR COMPANY AND INVESTOR DIALOGUE

Memorandum of comment submitted in May 2009 by The Institute of Chartered Accountants in England and Wales, in response to the European Alliance of CSR consultation paper *Valuing non-financial performance: A European framework for company and investor dialogue* published in November 2008.

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INTRODUCTION

1. The Institute of Chartered Accountants in England and Wales (the ICAEW) welcomes the opportunity to comment on the consultation paper, *Valuing non-financial performance: A European framework for company and investor dialogue* published by the European Alliance for CSR.

WHO WE ARE

2. The Institute operates under a Royal Charter, working in the public interest. Its regulation of its members, in particular its responsibilities in respect of auditors, is overseen by the Financial Reporting Council. As a world leading professional accountancy body, the ICAEW provides leadership and practical support to over 132,000 members in more than 160 countries, working with governments, regulators and industry in order to ensure the highest standards are maintained. The ICAEW is a founding member of the Global Accounting Alliance with over 750,000 members worldwide.

3. Our members provide financial knowledge and guidance based on the highest technical and ethical standards. They are trained to challenge people and organisations to think and act differently, to provide clarity and rigour, and so help create and sustain prosperity. The ICAEW ensures these skills are constantly developed, recognised and valued.

MAJOR POINTS

4. The aim of the project- to change the way that mainstream investors regard sustainability information and to incorporate it into decision-making - is both valuable and very timely.

5. We welcome the fact that the project, while advocating comparability and consistency of information, has not sought to be prescriptive about the information or the key performance indicators provided. It has instead focussed on outlining the areas that should be covered. This allows indicators and specific data reported to be the result of a bottom-up process of performance assessment by the management of a business that reflects the different circumstances of individual operations.

6. We think that it would be valuable to understand how this information would link into the Business Review and the Enhanced Business Review.

7. We believe the European Alliance for CSR should consider next in some detail how adoption by the investment community of this methodology might be achieved as we wonder if the generation of such information in itself would drive this. For example, what regulatory or legislative interventions might be necessary?

RESPONSES TO SPECIFIC QUESTIONS/POINTS

Q1: Do you think the information contained in the attached report is adequate to gain a general understanding of the laboratory's work including its objectives and deliverables?

8. While generally there is sufficient information in the report, there are areas which could add clarity. An explanation of the project's aims and ambitions might be a clearer way to start the report, rather than beginning with the diagram of the framework. Page numbers would be useful, as would a list of contents and perhaps numbering of sections and sub-sections.

9. It is not entirely clear what 'the framework' is. If the framework refers to the diagram on page two, we feel that that it needs greater explanation including a title.

10. The specificity of the arrows linking the 'core non-financial drivers' and the 'financial drivers' level in the framework imply specific direct causative links between individual non-financial drivers and individual financial drivers. Readers will reasonably infer this from the graphic and be looking to identify what the links are. If specific logical links are intended then they should be clearly explained; however if the intention is simply to show that non-financial drivers generally promote financial drivers, then to avoid confusion this would be better depicted in a different way. Similarly language is used such as 'there is an established link', but evidence is needed to substantiate how this was established.

11. In some places the draft appears to conflate 'non-financial' with 'ESG'. For example on page two it refers to 'a common set of non-financial core performance drivers' without restricting this to only those which are related to ESG. Furthermore the terms 'ESG' and 'CSR' are both used and it is unclear whether these are being used with different meanings, or effectively as synonyms?

12. Further explanation of certain terms would be useful. For example, the term 'information asymmetry' is used and the reader is left unclear as to whether the asymmetry being referred to is between companies and their investors, or someone else. Similarly, the phrase 'ESG broker teams' is also vague. Is it intended to mean something other than the teams of ESG experts that some investors employ or hire to provide information and advice, for example in order to support their ethical screening of potential investments? 'Practitioners' are not defined and the reader is left unclear as to whether these are investors, company directors or managers, for example, and the term 'partnerships' suffers from a similar lack of definition and explanation.

13. We would suggest that referencing follows the usual format which includes only brief citations in the text, with a full listing at the end of the report which provides sufficient detail to enable readers to obtain their own copies of what is being referenced.

Q2: What more would you like to know?

14. It would be useful to include in the background to the framework some detail about how regulation and legislation are likely to encourage adoption, and what other means a market economy has to drive shareholder behaviour. In our publication *Sustainability: the role of accountants* (2004) we argue that there is a range of mechanisms through which individuals, society and government can encourage business to promote sustainable development and become more sustainable themselves. These include not only mechanisms available to governments such as legislation and regulation but also that pressure can be

exerted by investors, businesses, consumers and civil society groups. Such a model might be employed to think about how investor behaviour might be shaped.

15. It would be helpful to make clear to whom the report and its findings are targeted and what it is aiming to achieve, for example whether it aims to inform, to persuade or to lobby?

16. Under the section 'The EFFAS partnership and focus group' on page four, the reader is left unclear about what the quantities at bottom right of the page mean and what is their significance. Since even the highest number is less than one-third of the total population of fifty five, on face value they do not appear to indicate very much, but more explanation is needed to clarify.

17. We feel that the framework would benefit from additional information around innovation and opportunities. Currently it appears more compliance driven. Companies that innovate and develop new products and services, which bring positive benefit to the environment and society, are often able to tap into new markets that bring additional revenue streams. We feel that the framework would benefit from an easily recognisable indicator that makes it possible for investors to identify this type of forward-thinking organisation, perhaps through a research and development indicator or from a KPI which tracks revenues from new products.

18. The report says 'Now we are in a situation … short-term drivers account for most if not all of market values'. This begs the question of what 'short-term drivers' are and seems to ignore or misrepresent much of the evidence on market efficiency. One indicator that markets are not necessarily short-termist can be seen in the average levels of P/E ratios. Despite the current economic situation most companies' P/E ratios are still in double figures. Since a P/E ratio is effectively a form of payback measure of the return on an investment in a company's equity, this would suggest that investors are not in fact taking a short-term perspective, which is what this statement in the framework could be construed to mean. The framework also states (on page 3) that "in normal times 50% to 75% of stock market values are determined by factors other than 5-year future earnings" could be construed as being intended to imply that at present, this is not the case – if so, can this be substantiated by any evidence?

19. We would question whether there is any evidence that the main contribution for most companies comes from brands, as suggested in the report, rather than other non-financial factors such as, for example, intellectual or human capital.

20. Under the 'market value' section of the report there is a graphic which includes an element of 'extra financial performance', which seems to represent the difference between market value and market capitalisation. This appears to contradict the concept of and evidence for market efficiency, without making this explicit. It also raises a question around what the definition of 'market value' means if it is a different quantity to market capitalisation?

21. In the same graphic in the 'brand value' section, the distinction between 'future earnings' and 'non-financial performance' seems illogical – isn't the significance of non-financial performance that it is a driver of future earnings and that the value of a company is defined entirely by its expected future earnings, discounted back to their present value at an appropriate risk-related discount rate?

22. We would be interested in how the framework aims to fit in with the UK Business Review (BR), the Enhanced Business Review (EBR) and the Operating and Financial Review (OFR). We believe there is a clear connection between the type of information examined by the framework and the reporting requirements here.

23. In the UK, the Companies Act (2006) requirements state that unless a company is subject to the small company's regime, the directors' report must contain a 'business review'. The purpose of the business review is to inform members of the company and to help them assess how the directors have performed their duties. It must include a 'fair review of the company's business', and include a description of the 'principal risks and uncertainties' facing that company.

24. The Enhanced Business Review extends this requirement for quoted companies. For these organisations the business review must now cover the main 'trends and factors likely to affect the future development, performance and position of the company'.

25. As well as including an analysis using financial key performance indicators, the business review must cover environmental matters including the impact of the company's business on the environment and the company's employees. This should include information about any company policy that refers to these issues and a consideration of the effectiveness of those policies. Again, there is clearly some overlap and for the benefit of UK users, it would be useful to clarify how the Alliance views this relationship.

26. Although companies are no longer required to produce a statutory Operating and Financial Review, some businesses do still choose to report separately under it or report on the information it covers, even if they do not give it an OFR label. It is therefore still a consideration and there is some overlap between this framework and the OFR. For example the primary audience for the OFR is also the investment community. Furthermore the OFR stipulates a description of the resources available to the company which include corporate reputation, brand strength, and R&D - factors that are covered to some extent in the 'ESG factors' of the framework.

27. We would question whether 'market value' is the best term to use in the framework. It might be better instead to think about long-term company value. As we have seen in recent months, companies can have a high market value but lose it very quickly or alternatively do very well on ESG factors but have low market value.

28. We should not necessarily equate the long-term creation of value with long-term investment. Markets are very efficient at price discovery and this means involving all players from short sellers and spot traders through to long-term investment. Similarly there is a role for private equity that is medium term and at its best takes failing businesses and turns them into better, well-performing assets that can be sold on.

Q3: What can the laboratory's framework contribute to improved dialogue between companies and investors?

29. We believe the framework is starting from the right place, trying to change the minds of mainstream investors. It asks exactly the right questions by looking at

how far investors attach value to ESG factors and how best this should be communicated. The framework gives a strong basis for engagement and discussion.

30. The framework is right to recognise that this will be a dynamic process. As investors become better informed about ESG issues they will no doubt redefine their informational requirements which may lead to changes in the framework.

31. We support the aims of the framework in providing comparability and consistency of information. We also recognise the difficulty in trying to measure ‘aspects of performance’ directly.

32. Hurdles may include the attitudes of companies who may claim that their unique strategy makes benchmarking against other companies unreasonable and the fact that we can not force investors to use this information.

Q4: How well can the framework be applied in your practical experience?

33. We predict that while some companies may welcome the framework, others may see it as yet more compliance and be resistant. There may also be some difficulty around take-up by investors who will want to see a causal relationship between ESG factors and financial performance.

34. It is perhaps unrealistic to say that investors’ interest in non-financial issues is very limited. It has long been recognised that analysts should and do take into account a wide range of relevant contextual factors. For example, analysts in the defence sector would be expected to obtain and use information on such contextual factors as geo-political developments, innovations in defence technologies, and political shifts as well as directly financial factors. The substantial interest which has developed over the last twenty years in ways for companies to measure their non-financial performance through models such as, for example, the balanced scorecard also evidences this.

35. From a company perspective, the framework will need more detailed guidance in order to make it practicable. As mentioned before we would need a better understanding of how it ties in with existing measures and regulation.

36. Under most definitions of terminology in performance measurement, for example in the GRI Guidelines, a distinction would be made between ‘category’, ‘aspect’ and ‘indicator/metric’. The items that the framework describes as ‘key metrics’ are ‘aspects’ rather than ‘indicators/metrics’.

37. Clarity is needed around the terms ‘accounting-based measures’ and ‘market-based indicators’ as it is not obvious what these are or what their implications are. Does this mean that accounting is more perceptive than the market, or does it cast doubt on whether business ethics training is worthwhile if the market does not appear to award it any value?

38. Succinct and practical guidance around methodology is needed. In particular the process by which users might identify, measure, and report on the principal ‘ESG factors’ and the overall type of ‘key metrics’ will need to be outlined in some detail. We suggest that case studies and examples that acknowledge the diversity between companies would be helpful. Following the style of Operating Financial Review guidance, we would suggest that the framework seeks not to be

prescriptive about KPI's and information. We urge The European Alliance of CSR to publish a set of headings under which companies can present relevant information for investors to refer to.

39. While we understand in principle the notion of each business sector having a small number of common KPIs we question whether this could be achieved in reality. We believe that any set of reports produced under a given regime, even within the same sector, would be diverse, with differing KPIs. Each business will have its own circumstances, including its own strategy and management approach, and the extent to which it makes use of particular performance management methodologies will vary. We do not therefore believe that it is appropriate to seek to 'define' the KPIs that will be relevant across particular sectors.

40. An undue focus on a list of particular KPIs is likely to diminish rather than enhance the prospects for improvement in company and investor communication as previously mentioned. This approach could result in companies focusing on improving outputs to meet 'investor targets' rather than on actual performance. For example, a company could simply improve its greenhouse gas emissions KPI by outsourcing its transportation requirements. The fact that this third party operator might be less efficient and create more greenhouse gases would be irrelevant to the company; its reported KPI would have improved.

41. Further we suggest that some companies will not have adequate systems in place to facilitate wide-scale data collection, that there may be issues with completeness of data, and that companies may not have the capacity to analyse this data themselves. We would suggest that further guidance for companies on these issues is developed.

42. More detail around the anticipated medium for communication and the format of this communication is also needed.

Q5: Are the principles relevant to the dialogue between companies and investors?

43. We agree in general terms with the principles and with their scope. However we found some were unclear, principle eight was a good example. Furthermore there appears to be some overlap between principles, from our perspective three and five were similar. We would suggest that a shorter number of succinct and disparate principles would be more effective and workable.

44. Contrary to principle four, we also suggest that key metrics should be chosen by business themselves, allowing indicators to be the result of a bottom-up process of performance assessment that reflects the different circumstances of individual operations.

Q6: What recommendations are required to enable widespread adoption of the framework and principles, by companies, investors, accounting and industry bodies and regulators?

45. Again the Alliance should refer back to *Sustainability: the role of accountants* (2004) which outlines the mechanisms within a market that can encourage companies to become more sustainable. Companies are more likely to be persuaded to adopt the framework if environmental, social and economic issues begin to appear as a cost or revenue on their income statement through fines,

taxes, subsidies, consumer power or efficiencies. Therefore those companies who are already performing well on these factors are likely to adopt the framework because they see the likely benefit it could have on their share value.

46. Investors and analysts will adopt them in their buying and selling decisions and their recommendations when they are convinced ESG factors have caused improved financial performance and share price. Establishing a correlation is possible - Towers-Perrin (2007) for example found that greater workforce engagement, a non-financial measure, is correlated with financial performance. However inferring cause is more difficult.

47. This means that the European Alliance for CSR need to embark on a project to convince both investors, communities and companies of this and to build a group of governments and professionals to support it, backed by a solid base of evidence.

Q7: What further research is necessary in this area?

48. There is some evidence that ratings agencies may have begun to use information on carbon to influence investor decisions. It may be worth examining more closely how and why this has and has not worked so far.

49. We suggest that research into why mainstream investors were not interested in these factors in the first instance would be valuable. Furthermore, an investigation into why companies do not disclose the information in which investors are already interested is recommended. An evidence base for each of these points needs to be developed to form the basis of future thinking. We suggest that the Alliance then looks at how the framework might help to overcome whatever the obstacles to disclosure are.

50. An important consideration is the impact that reporting frameworks such as this have on their users, and whether reporting ESG information changes behaviour. This is the focus of a project we are working on with our partners Tomorrow's Company and Cranfield University called *Beyond Accounting*. We would be happy to explore opportunities to work together on this project.

51. The 'non-financial' aspects of business are very broad and it is difficult to define how they contribute to market value (or however we define the objective), so this would be an area for interesting research.

Q8: Would you welcome the opportunity to participate in development of the laboratory's work?

52. Yes, we would be very interested to hear about the progression of the project and contributing where relevant.

Email: rachel.bird@icaew.com

www.icaew.com