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cutting through complexity

Capital markets in the dark: an unsustainable state of play

Better Business Reporting

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Foreword

Sustainability reporting originated around 20 years ago, initially as 'environmental reporting'. Early environmental reports typically focused on reporting the environmental performance of companies. They made little attempt to relate environmental performance to financial outcomes, or to the inherent value of this performance to the capital markets. Since that time, sustainability reporting has evolved with significant pace to the point where the sheer breadth and scope of issues covered is now greater than ever before.

The sustainability reporting evolution reflected a demand by particular stakeholder groups for information that conventional financial reporting was not delivering. However, throughout its evolution, sustainability reporting typically lacked focus on the information concerns and needs of the capital markets, particularly in relation to overall business strategy and value creation processes.

A significant amount of activity across a diverse range of stakeholders is now driving change in sustainability reporting and businesses are becoming increasingly aware of the importance of ESG matters in business strategy formation. This in turn is leading to an increasing desire by the capital markets to understand performance in relation to ESG matters through sustainability reports.

In this third paper of our Better Business Reporting series, we explore the steps businesses can take now to enhance sustainability reporting and improve communication with the capital markets. Enhancing sustainability reporting offers significant potential benefits including a more accurate valuation of the company by the capital markets as well as potential cost savings.

We hope this report will be of interest. If you would like to discuss any of the ideas explored here, please contact your KPMG adviser or one of the professionals listed at the back of this publication.

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1 Executive summary

This paper puts forward the case for business, and CFOs in particular, to act now and enhance sustainability reporting to better meet the information needs of the capital markets.

While it is recognised that sustainability reporting provides value to a number of other stakeholders, the focus of this paper is on the use of ESG performance information by the capital markets.

There is still a long way to go before sustainability reporting can be regarded as fully informing the capital markets on ESG matters. However, there are steps businesses can take now to enhance the quality of their sustainability reports and significant potential benefits of doing so.

1.1 The benefits

The benefits of enhancing sustainability reporting are many. They include:

- A better understanding of the organisation's business strategy, both internally and externally.
- An improved basis for capital allocation and reputation determination by key stakeholders.
- Better alignment between internal and external reporting.
- Cost reduction opportunities.

1.2 Enhancing sustainability reporting

To date, the capital markets have largely been in the dark when it comes to recognising ESG performance and value. To improve the utility of ESG information to the capital markets, the link between ESG performance and financial performance needs to be better understood. Investors must also have a strong understanding of the organisation's overall business strategy, including the company's strategic objectives and business model, its expected cash flows and the risks to those cash flows, so that they may align their models accordingly. In order to achieve these outcomes, businesses should focus on three key issues in enhancing their sustainability reporting practices:

- Explaining the integration of ESG matters into the business strategy.
- Describing performance in executing the strategy in terms of ESG KPIs.
- Providing insights into ESG performance prospects.

This paper provides a roadmap for how businesses can take these steps today.

1.3 The journey to better business reporting

Together, enhancing sustainability and financial reporting are part of the journey to better business reporting, which will culminate in the development of an integrated report according to the framework currently under development by the International Integrated Reporting Committee (IIRC). Businesses that enhance their sustainability reporting and financial reporting today, and integrate the key features of both into management commentary, will be well placed to derive the significant benefits that will come when they move to an integrated report as their main report.

Sustainability and ESG defined

We use the term 'sustainability reporting' as a generic term to describe the various business reports developed over the past two decades to report on a range of non-financial data. This reporting has covered environmental reports, triple bottom line reporting, health, safety, environmental and community (HSEC) reports, corporate social responsibility (CSR) reporting and environmental, social and governance (ESG) reports. Sustainability reporting is typically used to describe reports prepared for the information of stakeholders other than those in the capital markets. Financial reports are prepared mainly for stakeholders associated with the capital markets (investors, fund managers, lenders, rating agencies, analysts).

Sustainability reporting today covers non-financial information, including (but by no means limited to) key performance indicators relating to environmental, social and governance (ESG) strategies, processes, risks and opportunities and performance, referred to generally in this paper as 'ESG matters'. Thus sustainability reporting can now be considered to encompass the financial and economic sustainability of the enterprise as well as its effects on environmental sustainability.

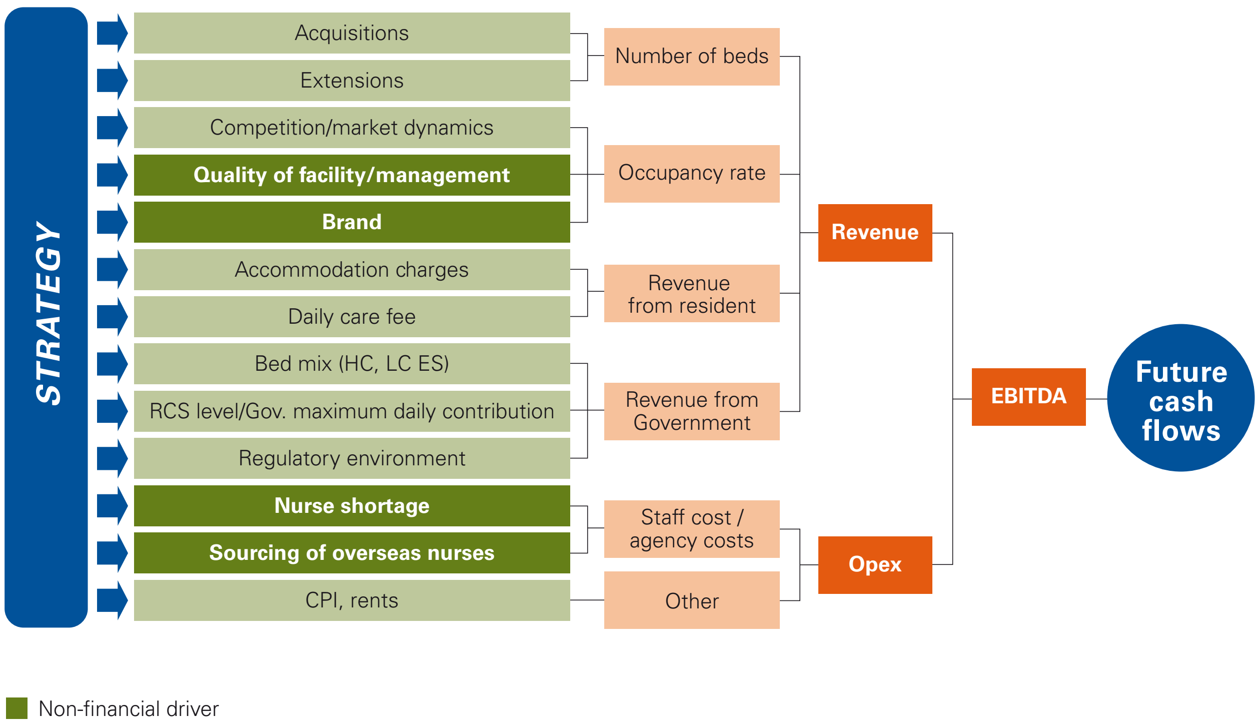
2 The sustainability reporting challenge

Astute market observers now recognise that strong environmental and social management, good corporate governance and an understanding of stakeholder concerns underpin corporate reputations. These factors are also features of effective business strategy and are therefore highly relevant to capital allocation decisions.

Effective management of ESG matters is critical to the ongoing success of a business. For their part, capital markets initiatives increasingly acknowledge the relevance of ESG matters. Market and academic research shows a correlation between ESG performance and capital allocation decisions. Modern practice is introducing greater intellectual rigour to sustainability reporting.

One critical step in enhancing sustainability reporting is to clearly identify and communicate the link between strategy, performance and future cash flows (Diagram 1).

Diagram 1: Link between strategy and cash flows – a simplified example from the aged care sector

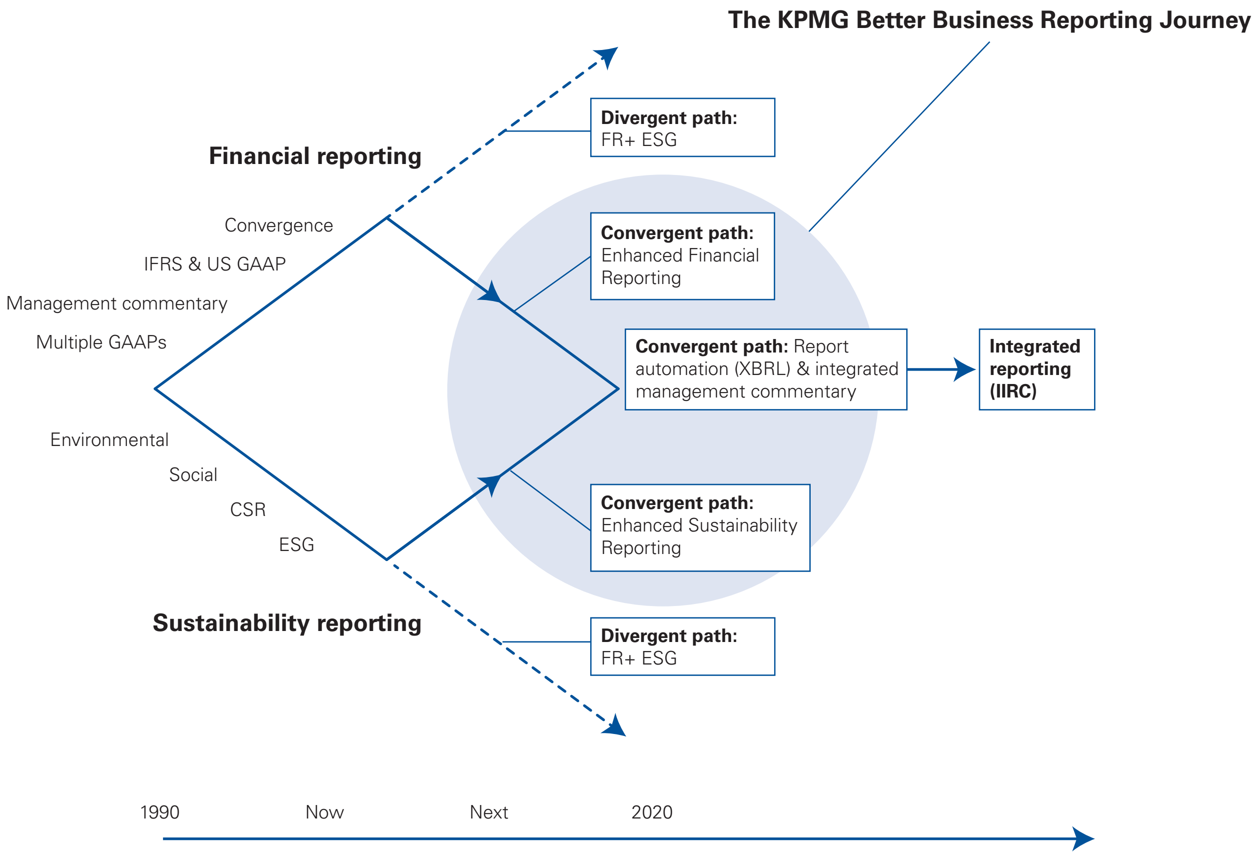


Source: KPMG

Diagram 1 demonstrates that these links not only exist but are often closely managed. However, communicating these links to the capital markets remains problematic. The diagram also demonstrates that ESG performance is important to all industries, including aged care, and is not the sole domain of the mining industry. While the capital markets are starting to seek better ESG information, the techniques for building this information into capital allocation processes are only now emerging.

Some would argue that sustainability reporting has historically been used as a marketing tool by businesses to report 'good deeds' performed during the year. This progression has seen business reporting split and sustainability reporting diverge from financial reporting. This dichotomy ultimately leads to inefficient and ineffective reporting across the business spectrum. The historic reporting path and KPMG's objective to improve and converge reporting, through its Better Business Reporting initiative, is shown below:

Diagram 2: Potential development path for better business reporting



Source: KPMG

Simply adding financial information to current sustainability reporting does not create value for either the capital markets or other stakeholders, and merely continues business reporting on a divergent path. Enhancing sustainability reporting (as described in this paper) or enhancing financial reporting (as described in the second paper of KPMG's Better Business Reporting series[i]) changes the trajectory towards truly integrated reporting.

> **Six out of 10 businesses see real benefits from adopting sustainability strategies.**
>
> *Source: 2010 survey by KPMG International and the Economist Intelligence Unit of 378 companies across 61 countries.*

There have been a number of attempts at developing a sustainability reporting framework during this evolution. However, these frameworks have not been focused on the capital markets as primary users. Capital markets are already swamped with financial information in the form of financial reports and management commentary. They face inherent difficulties building ESG information into their decision-making models (e.g. as assumptions, inputs to discount rates, or as the basis of cash flow estimates). As a result, the capital markets largely remain in the dark when it comes to recognising ESG performance and value.

Accordingly, sustainability reporting lacks a context and framework that connects ESG information with the information needs of the capital markets. In addition, there has been little attention given to how ESG performance contributes to performance prospects, or how this information should be communicated in management commentary. These are critical matters for CFOs, as well as for CEOs, boards of directors and others in communicating with external stakeholders and maintaining business reputations. Capital allocation is at stake, and without a reputation, there will be no capital allocated.

Contemporary aspirations for business reporting revolve around an integrated report prepared according to the International Integrated Reporting Committee's (IIRCs) integrated reporting framework, which is currently under development. Businesses that enhance their sustainability reporting and financial reporting today, and integrate the key features of both into management commentary, will be well placed to derive the significant benefits that will come when they move to an integrated report as their main report.

The IIRC framework offers great potential as a reporting solution, but there is a still some way to go. Development of the integrated reporting framework will take much of 2011. An exposure draft of an integrated reporting standard could take until late 2012 to release. Only then will widespread global adoption be feasible. An integrated reporting standard, endorsed by the G20 and IASB, is targeted for 2013.

Given the business imperative for integrated reporting, companies should act now to enhance their existing sustainability reports, financial reports and management commentaries, using the conceptual underpinnings and framework of integrated reporting. The remainder of this paper considers how sustainability reporting can be enhanced, and the benefits for businesses of doing so.

3 Benefits of enhancing sustainability reporting

The benefits to businesses, particularly CFOs, but also CEOs and Boards, of enhancing sustainability reporting are many.

- **Capital markets' understanding and decision-making –** If the capital markets can fully understand a company's strategy, including how ESG elements 'fit' with the financial aspects, they will have greater insight into how ESG matters affect performance and business value. It encourages a more in depth and insightful understanding of the business leading to more precision in the models and assumptions deployed by analysts and investors and a more accurate company-specific cost of capital.
- **Perceived management quality –** Some sectors of the capital markets are already using ESG metrics as a proxy for management quality. Better reporting ESG matters can provide greater influence over the capital markets' determination of management quality and performance.
- **Alignment of internal and external reporting –** While ESG issues may already be understood and considered by management, enhanced sustainability reporting provides management the opportunity to better communicate the underlying strategy and performance of the business. As well as the key factors that influence the overall performance of the company, management can use sustainability reporting as an enabler to demonstrate how company value and success is managed and measured internally.
- **One reporting process and cost reduction opportunities –** Centralised reporting and communication channels provide a more consistent picture of the business to the capital markets, which means that everyone is on the same page. In addition, the existence of a single process covering all reports, including enhanced sustainability and financial reports, may offer significant cost reduction opportunities. Indeed, the savings achieved may allow the costs incurred in enhancing these reports to be self funded.
- **Risk management –** A wider consideration of the issues that influence the financial performance of the business can facilitate better risk management of both ESG risks as well as more traditional financial risks. For their part, the capital markets end up with a better perspective on the overall risk portfolio and risk management capabilities of the business.
- **Staying ahead of the reporting curve –** There is an increasing expectation in the community and in the capital markets that reporting on ESG factors will become mandatory, if not by law, then by dictums of best practice and corporate reputation. The capital markets will also become informal standards enforcers by demanding certain disclosures and reporting formats. Enhancing sustainability reporting now will ensure that your business is capable of identifying and reporting on ESG matters before it becomes a statutory obligation or a market imperative.

> **More senior executives than ever before are viewing sustainability not as a monolithic challenge that must be avoided, but as a diverse set of opportunities that, properly managed, can deliver significant competitive advantage.**
>
> *Yvo de Boer, Global Adviser to KPMG and former Executive Secretary, United Nations Framework Convention on Climate Change.*

3.1 Be part of the debate

Some sectors of the capital markets are already using ESG information as part of their valuation models. It is our expectation that this trend will continue. Those that work with the capital markets now should be rewarded with a more appropriate capital allocation, and be positioned to benefit further as integrated reporting becomes mainstream.

The capital markets today are often using information that is sourced by third parties. This often involves relying on untested information from a variety of sources, forcing greater assumption and extrapolation than is desirable, and reducing the influence and control of management over the factors deemed important to the value and prospects of the business.

By communicating with transparency and providing information directly to the capital markets for their decision-making models, businesses will have greater control over the information provided and can offer greater insight and context for reported performance.

3.2 What's in it for me?

CFOs will benefit in several ways from enhancing sustainability reporting, as set out above. These benefits come down to a more accurate valuation of the company by the capital markets and a more realistic understanding of its prospects. It will also have the potential to reduce the cost of reporting and enhance its quality.

For **CEOs**, improving sustainability reporting and integrating reporting overall offers the opportunity to enhance strategic clarity by formulating a single view of the organisation's business strategy, both internally and externally. This in turn, becomes a performance improvement opportunity.

Boards of Directors should welcome the opportunity to quickly capture the benefits of enhancing and integrating financial and sustainability reporting. It allows Boards to launch a united 'attack' on the 'market for reward' – capital and reputation. Benefits can be obtained without inflating the board agenda as the necessary systems and processes become embedded in the business.

4 Capital markets are waking up to the relevance of ESG performance

An increasing recognition of the importance of ESG matters can be seen within the capital markets, individual businesses, stock exchange activity, and the formation of the IIRC, one of the most significant developments in business reporting in recent years. These factors suggest that it is worth the effort for CFOs to ensure that ESG performance is properly highlighted in sustainability reports and integrated management commentary, given the capital markets rewards on offer.

4.1 Investor initiatives – the UN PRI

The UN backed Principles for Responsible Investment (PRI) initiative is a case in point. The PRI is a network of nearly 900 institutional investors from various parts of the world (including around 100 from Australia) collectively managing almost US$22 trillion in assets as at July 2010. The network seeks to promote its six 'Principles for Responsible Investment'. Signatories to the PRI make the following commitment:

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and corporate governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following principles:

Principle 1	We will incorporate ESG issues into investment analysis and decision making processes.
Principle 2	We will be active owners and incorporate ESG issues into our ownership policies and practices.
Principle 3	We will seek appropriate disclosures on ESG issues by the entities in which we invest.
Principle 4	We will promote acceptance and implementation of the Principles within the investment industry.
Principle 5	We will work together to enhance our effectiveness in implementing the Principles.
Principle 6	We will each report on our activities and progress towards implementing the Principles.

KPMG research indicates that nearly a third of the share capital of the ASX 20 is held by signatories of the UNPRI.[ii] The significant PRI uptake among Australian institutional investors indicates that these investors regard ESG matters as important issues that should be taken into account in their decision-making processes.

4.2 Formation of the International Integrated Reporting Committee

The formation of the IIRC represents an important development in business reporting.

The IIRC's goal is to drive change in the current format and process of business reporting. To guide debate and development of the integrated reporting framework, the group has set out a five-point plan:

1. Support the information needs of long-term investors by showing the broader and longer-term consequences of decision-making.
2. Reflect the interconnections between environmental, social, governance and financial factors in decisions that affect long-term performance and condition, making clear the link between sustainability and economic value.
3. Provide the necessary framework for environmental and social factors to be taken into account systematically in reporting and decision-making.
4. Rebalance performance metrics away from an undue emphasis on short-term financial performance.
5. Bring reporting closer to the information used by management to run the business on a day-to-day basis.

The IIRC is well placed to bring together all of the relevant parties necessary to drive the business reporting agenda. Many key market participants expect that this group will drive significant change across both financial statement reporting and sustainability reporting processes, both in Australia and internationally. The IIRC expects to release an integrated reporting exposure draft by 2012 with an integrated reporting standard endorsed by the G20 and IASB by 2013. A pilot program is runing concurrently with the development of the integrated reporting framework. The value of the IIRC's contribution will manifest itself over time as opposed to short-term enhancements to sustainability reporting.

4.3 Other ESG initiatives

Other observations supporting the growing importance of ESG performance include the following:

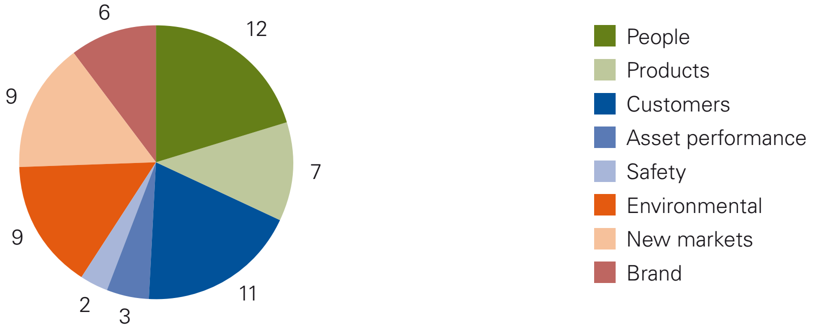
- Brokers looking to add ESG analytical capability to their skill set to enable significant investment and M&A activity in ESG research.
- The inclusion of ESG capability in the broker panel requirements of institutional investors.
- Increasing integrated reporting activity in international stock exchanges. For example, the Johannesburg Stock Exchange recently issued a requirement for the top 400 listed companies to issue an integrated report as their main report for years beginning on or after 1 April 2011 while the Danish Stock Exchange requires companies over a certain size to provide reporting on their responsibility to society.
- The *ASX Corporate Governance Council's Principle 7* requires companies to make an informed disclosure about their management of material business risks, including sustainability risks.
- The formation of *ESG Research Australia* – a group of institutional investors committed to contributing a percentage of funds to encourage ESG research and analysis.
- Bloomberg now includes ESG performance metrics on its analyst screens.
- The formation of the *Investor Group on Climate Change Australia/New Zealand* representing institutional investors with over $600 billion under management which aims to encourage the inclusion of climate change impacts in investment decision making.
- An exponential increase in the number of ESG questionnaires and enquiries received by companies.
- The existence of the *Carbon Disclosure Project* which collates and reports corporate climate change information on behalf of institutional investors.

4.4 Corporate developments in promoting ESG performance

4.4.1 ESG in strategy

Businesses increasingly recognise that the management of ESG performance is important to their business strategy and the creation and maintenance of business value. A KPMG review of the ASX 20 identified a link (at least at a high level) between ESG matters and company strategy with 18 companies including a reference to ESG matters in publicly available strategy documents.

Diagram 3: Number of ESG factors identified by ASX 20 companies in reports on strategy



Source: Financial reports of ASX top 20 companies, 2010

4.4.2 ESG in business processes

Leaders in sustainability reporting are beginning to consider the ESG operating risk across their supply chains as they look to manage ESG risks over which they have influence. Companies are increasingly managing these risks through a tender process with suppliers' ESG credentials now forming part of the selection criteria, effectively pushing the requirement to monitor and manage ESG performance down the supply chain.

As a part of their own core businesses, many financial institutions are focusing on ESG factors. Westpac, for example, has publicly stated that ESG factors are being considered in its credit processes, as this extract from its 2010 *Sustainability Matters* report[iii] confirms:

> **Applying ESG considerations throughout the credit process**
>
> Our credit process incorporates ESG risk analysis into the assessment and approval process for business, corporate and institutional customers in line with our ESG Credit Risk Policy. The policy requires that ESG risk is considered in each stage of our credit cycle, as outlined in the following summary of the policy.

> **A recent survey of CEOs from United Nations Global Compact signatories found that 81 percent of CEOs – compared to just 50 percent in 2007 – stated that sustainability issues are now fully embedded into the strategy and operations of their companies.**
>
> *Source: A new era of sustainability: UN Global Compact – Accenture CEO study, 2010*

Accordingly, Westpac wants its borrowers to report on ESG matters to assist with its credit processes, leading to a demand for management and reporting of ESG issues.

4.4.3 ESG in reporting

The number of companies reporting ESG matters continues to increase with 64 percent of the ASX 20 producing standalone sustainability reports and 93 percent of ASX100 companies providing ESG performance information at least at a basic level.[iv]

Despite these seemingly high levels of reporting by Australian companies, there is still significant variation in the quantity, relevance and quality of sustainability reports produced, with no formal framework being consistently adopted for reporting sustainability performance to the capital markets.

A growing number of businesses that produce standalone sustainability reports reference the Global Reporting Initiative (GRI) reporting framework. However, most ESG information continues to be prepared with little or no reference to any recognised sustainability reporting framework.

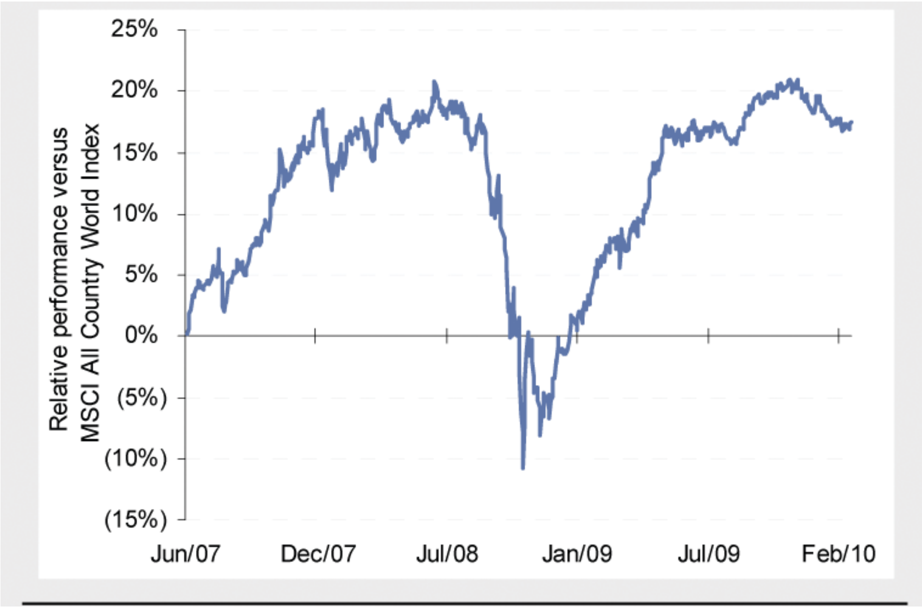
The number of Australian companies seeking assurance over their sustainability reports reached 25 percent of ASX 100 companies in 2010 and the trend towards assurance is expected to increase further in 2011.[v] Most ESG performance data made available to the capital market is un-assured and is essentially self-declared. This raises questions about the comparability and reliability of the ESG information presented.

4.5 Market and academic research

Several recent market-based ESG performance indices and broker research papers suggest a company's reported ESG performance is positively correlated with an improvement in its capital markets ranking relative to competitors:

- The GS SUSTAIN investment framework developed by Goldman Sachs identifies companies considered to be in the best position to sustain superior returns in the long-term. The identification process combines analysis of expected returns with measures of industry positioning and management quality (based on ESG matters). The GS SUSTAIN Focus List has regularly outperformed the MSCI All Country World index since inception in June 2007 (Diagram 4).
- The Dow Jones Sustainability Index (DJSI) selects leading sustainability focused companies as part of the index. Leaders are selected on the basis of an ESG specific questionnaire. Companies that achieve a score above the benchmark are selected for inclusion in the index. Based on research by A.T. Kearney, the DJSI has outperformed the Dow Jones Industrial Average consistently over the last 5 years.[vi]
- Research company SAM released the results of a study which showed that the annual share performance of sustainability leaders exceeded that of companies that show little or no commitment to sustainability by 1.48 percentage points during 2001-2008.[vii]

Diagram 4: Performance of GS SUSTAIN Focus List vs MSCI All Country World index



Source: Datastream, MSCI, Goldman Sachs Research

A number of long running academic studies also identify strong links between ESG performance and the cost of capital:

- A study of 581 US companies between 1995 and 2006 identified a strong link between environmental practices and the cost of debt and credit ratings.[viii]
- A US study identified a positive link between employee satisfaction and shareholder returns, where a value weighted portfolio of the '100 best companies to work for in America' performed 2.1 percent above benchmark between 1994 and 2009.[ix]
- A joint US and Hong Kong study identified a positive link between ESG performance and the cost of capital.[x]

“Having regard to ESG performance as well as historic financial performance allows greater depth of analysis and more accurate valuations. I would like ESG information to be reported to help overcome a time consuming search for information, with potential incompleteness and inaccuracies, to an improved quality of information in reports with assurance. This would assist analysis by enabling a better information flow on metrics that can directly impact valuations.”

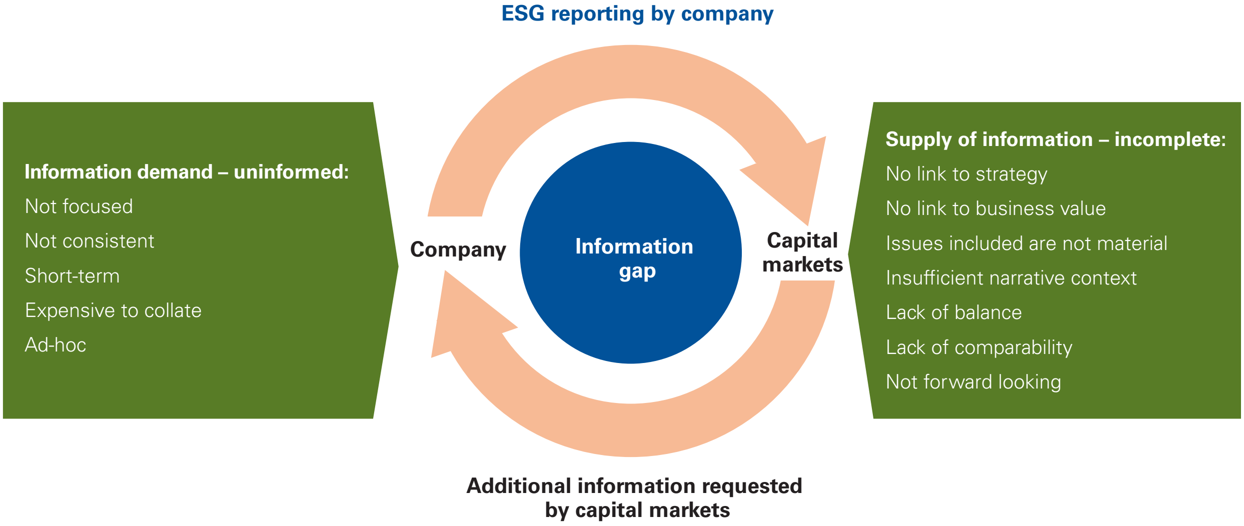
Andrew Gray, Executive Director, Head of ESG Research, Goldman Sachs

5 Weaknesses in current sustainability reporting and their causes

The quality of ESG information in sustainability reporting today leaves significant room for improvement.

Weaknesses in both the supply and demand sides of the reporting framework create an information gap that undermines the potential value of sustainability reporting and its endorsement by CFOs and the capital markets.

Diagram 5: The ESG information gap



Source: KPMG

5.1 Gaps in ESG information, sustainability reports and assurance

Through our discussions with a variety of capital markets participants – including mainstream investors, institutional investors, research organisations and certain socially responsible investment funds – we have identified several recurring sustainability reporting weaknesses.

- **Poor link between strategy, performance and business value –** the link between strategy, performance and overall business value is not explained. Data is provided without sufficient narrative to enable information to be put into a strategic context. Few targets are set and performance against targets is rarely explained (especially if the target is not met).
- **Not material –** many issues identified and disclosed are not material to capital markets decision making, leading to further questioning by the capital markets and those who lead the interaction with the capital markets (such as CEOs and CFOs). This is not to say that the information reported is not of value to stakeholders, but it is of limited utility for the broader decision making process.
- **Lack of balance –** reporting focuses on one-off descriptions of good examples (case studies and examples of best practice) rather than a balanced view of overall performance, both good and bad.
- **Lack of comparability –** ESG KPIs are not consistently selected, defined and reported between businesses, industries or even within reporting periods.
- **Not forward looking –** disclosure currently includes data on past performance without any accompanying forecasts or targets.

5.2 Possible reasons for the gaps: the company perspective

There are a number of explanations for the current weaknesses in sustainability reporting.

ESG matters are not integrated into the business strategy	Lack of generally accepted sustainability reporting framework (including inclusion of ESG KPIs)	Lack of understanding of the scope and capability of ESG management responses
• The executive management team often has little ongoing visibility of the information in the sustainability report. • Sustainability reports are prepared by the sustainability manager and/or marketing group, are not reviewed by executive management or the board, and are not written for a capital markets audience. • There is often little communication between the sustainability manager, the investment relations officer and the strategy function. • Management themselves often do not understand the strategic connections between ESG and value creation and therefore do not identify the relevant performance areas or management approaches to dealing with them.	• Assessment of the strategic importance of ESG information is either missing, or key information is incorporated late in the process. • Reporting is voluntary and third party assurance is not mandated.	• Information of interest is often removed or watered down, and data relating to underperformance is described as an 'opportunity', or is simply removed. • There is little consistency between data requests from the capital markets. Some analysts want detailed metrics whereas others require narrative information over a wide range of potential risks.

Even though businesses and the capital markets are increasing their focus on ESG management and sustainability reporting, an information and credibility gap remains. The failure to integrate ESG matters fully into business valuation models and capital allocation decisions represents a significant market failure leading to misalignment and lack of precision in decision making. It also offers a significant opportunity for CFOs to take charge of the sustainability reporting agenda.

> **Sustainability reporting produced by most companies today… lacks logic and cohesion, is disjointed, increasingly voluminous and, perhaps most critically, lacks strategic focus and comparable disclosure of those non-financial factors fundamental to long-term business success.**

Source: Governance & Collaboration – Establishing an International Integrated Reporting Committee, May 2010.

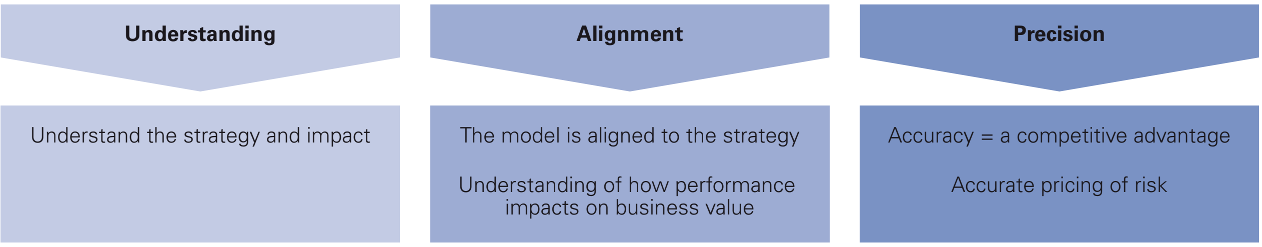
6 Enhancing sustainability reporting

To enhance sustainability reporting, the links between ESG performance and financial performance need to be better understood. This understanding will allow ESG performance to be reflected in the valuation model through adjustments to estimates of future cash flows, thereby using ESG performance as a lead indicator of financial performance.

Investors want to model projected business performance as accurately as possible. Their ability to do this depends on their **understanding** of the organisation's overall business strategy, which includes understanding the company's strategic objectives and business model, its expected cash flows and the risks to those cash flows, so that they may **align** their models accordingly.

The lack of **precision** in current modelling reinforces uncertainty in capital allocation. Capital markets want strategically important information that improves the precision of their model and increases their confidence in the ability of management to achieve its forecasts. Thus ESG KPIs are now strategically important.

Diagram 6: Modelling business performance



Source: KPMG

It is widely recognised that incorporating a high level of ESG KPIs into capital allocation decisions is not currently possible given the lack of quality of these KPIs and inconsistencies in sustainability reports, reinforced by a relatively immature understanding of how the strategic linkages between ESG and financial performance should be reflected in valuation models.

This has led to a number of 'sub-optimal' methods being adopted by the capital markets. However, sub-optimal decision-support methods are preferable to 'no method' at all.

6.1 How do capital markets use ESG information?

Three broad methods for incorporating ESG matters into investment decision making have been developed: screening, engagement and integration.

Diagram 7: incorporating ESG matters into investment decision making

Screening	Engagement	Integration
• Investors choose a set of criteria against which to monitor performance. • Companies screened on a absolute basis – eliminating companies with specific features, or relative performance screening of the lowest ranked companies. • Focus on responsible behaviour rather than material link to financial performance.	• Non-financial reporting used to identify risks and opportunities. • Discussion with management. • Tend to be issue specific. • Investors need a breadth of understanding of non-financial issues.	• Non-financial information integrated into existing decisions making techniques. • Interested in non-financial data that has a material impact on business performance.

Source: KPMG

Of the these three methods, 'integration' is likely to best suit the mainstream investor. However, the current level of integration by mainstream investors is generally much less sophisticated than the full integration model described above, even for those that are PRI signatories. Critical information is simply not available.

It is more likely that performance on ESG matters is reflected in a valuation model through an adjustment to the discount rate. This adjustment is often made to reflect the capital market's perception of management's ability to identify, categorise and manage longer term risk across a wide range of issues, including ESG matters, and therefore its ability to achieve forecast performance (including financial results). Some analysts have taken the next step and developed a formal methodology to consider a company's ESG performance measured by a number of KPIs. Such analysis is used to determine a more informed business-specific discount rate. ESG performance is therefore directly, and systematically, influencing the valuation of the business.

6.2 Sustainability reporting – the way forward

The steps required to improve sustainability reporting to meet the information needs of the capital markets can be split into three broad categories.

- **Strategy –** explain how ESG matters fit within the business strategy in terms of strategic objectives, business model (processes, people and systems) and specific ESG KPIs that measure progress towards the strategic objectives and the performance of relevant aspects of the business model.
- **Performance –** describe performance in executing the strategy in terms of ESG KPIs and their relationship to other KPIs that measure progress towards strategic objectives and the functioning of the business model. The setting of goals and targets (which are linked to executive remuneration) will further enhance the understanding of the capital markets.
- **Insight –** comment on prospects for the future. Assuming that the strategy is well executed, what will future performance look like compared to the strategic objectives, focusing on ESG matters and related KPIs?

The other important factor is clear and transparent **communication**. It is critical for ensuring that the reporting of strategy, performance and prospects, particularly in relation to ESG matters, is clearly understood by the capital markets and is being used to enhance their decision-making processes.

Diagram 8: Enhancement process

Strategy	Performance	Insight
Identification of material ESG issues	Identification of KPIs capable of measuring performance against strategy	Narrative context of performance
Long term focus	Robust data collection	Benchmarking
Consideration of value chain	Internal reporting process	Targets/forecast
Understanding of impact of ESG issues on business value	Embed performance into executive management remuneration	Link between KPI and business value
Integration of ESG issues into strategy		Education of capital markets as to importance

Communication

Understanding	Alignment	Precision

Source: KPMG

6.3 Incorporate ESG risks into the strategy

Understanding a company's strategy is a critical step in the valuation and capital allocation process. The strategy is a company's response, among other things, to risk and opportunity, including those pertaining to ESG matters.

The first step in explaining the integration of ESG matters into the business strategy is to ensure that all ESG risks and opportunities have been identified and reported. Diagram 9 from Westpac's 2010 Sustainability Report shows the material issues identified by the bank at that time.

Diagram 9: Westpac sustainability report – key issues

Source: 2010 Westpac sustainability report

This identification and reporting process allows all external and longer-term issues to be reported on by the company in an integrated way. A process to determine the materiality of issues identified is applied to ensure that only material issues are considered in reporting. The process to determine which issues are material to all of a company's key stakeholders is often complex. It also often leads to a high number of issues being initially identified as warranting reporting, with that number being progressively whittled down.

6.4 Respond to material issues

The next step is to consider an appropriate response to the material strategic issues identified. This extract from Qantas' 2010 Databook shows Qantas' key risks and opportunities, as well as the company's response.

Diagram 10: Risks and opportunities – Qantas

Industry risks and opportunities	Examples of the Qantas Group response	Reference for further information
Strategic		
Competitiveness including capacity, consolidation and alliances – remaining competitive in a highly competitive and volatile industry	– Fleet renewal to reduce long term costs and grow revenues	Page 45 AR
	– Strong alliance relationships and strategic investments to spread risk and opportunity across markets and provide network depth	Pages 43 - 45 DB
	– Qantas: innovations to drive higher satisfaction and improved customer advocacy; focus on end-to-end customer experience; improvements in product consistency across the fleet including aircraft reconfiguration; brand renewal; pursuit of efficiencies to lower the cost base; Customer Charter established	Pages 30 – 31 AR
	– Jetstar: effective capacity management; strong promotional campaigns; ground breaking strategic alliance relationships (e.g. AirAsia); Customer Charter established	Pages 36 – 37 AR
Brand and reputation – enhancing brand strength and customer advocacy	– Detailed customer research to drive improvements	
	– Extensive program of sponsorships, planned giving through staff initiatives and the Qantas Foundation	Pages 63 – 64 AR
	– Industry partnerships to promote tourism, business and events	
Emerging markets – ability to pursue growth opportunities and sustainably manage differences in operations, regulations and culture	– Qantas alliance relationships with carriers in emerging markets (e.g. China Eastern)	Pages 43 – 45 DB
	– Jetstar Pan Asian strategy including Jetstar Pacific (based in Vietnam) and Jetstar Asia (based in Singapore)	Pages 36 – 37 AR

Source: 2010 Qantas Data Book

The Qantas Data Book is a report targeted at the capital markets with the intention of enabling risks and opportunities to be better understood and reflected in capital markets modelling. This message and an analysis of Qantas' ESG performance is reflected in a recent RBS analyst report:

Diagram 11: RBS analyst report

Qantas Airways

ESG factors trending positively

QAN has embraced ESG reporting, which in our view is important in such a challenging industry. In this note we update QAN's FY10 sustainability performance in detail, noting it was generally positive across most measures. With QAN trading below 1.0x P/B, we maintain our Buy recommendation.

Key forecasts

	FY09A	FY10A	FY11F	FY12F	FY13F
EBITDA (A$m)	1,424	1,619	2,185	2,813	3,078
Reported net profit (A$m)	117.0	112.0	532.1	868.8	1,009
Normalised net profit (A$m)[1]	86.20	251.3	532.1	868.8	1,009
Normalised EPS (c)[1]	4.16	11.20	23.60	37.90	43.10
Normalised EPS growth (%)	-92.2	168.6	110.9	61.00	13.70
Dividend per share (c)	6.00	0.00	12.00	18.00	19.00
Dividend yield (%)	2.45	0.00	4.90	7.35	7.76
Normalised PE (x)	58.90	21.90	10.40	6.46	5.68
EV/EBITDA (x)	5.22	4.67	3.79	3.14	2.92
Price/net oper. CF (x)	5.01	3.74	3.15	2.54	2.41
ROIC (%)	1.50	3.97	7.25	10.10	10.30

1. Pre non-recurring items and post preference dividends
Accounting standard: IFRS
Source: Company data, RBS forecasts

year to Jun, fully diluted

2010 ESG data points largely trended well

On a majority of the ESG data points we track, QAN trended positively in FY10 (see Table 1). Positively, fuel efficiency continued to improve as new aircraft were brought into the fleet (ASK/bbl increased by a solid 2.7% on the pcp), governance measures strengthened, and operational performance (on-time arrivals and load factor) improved. On the negative side, the lost time injury frequency rate (LTIFR) increased marginally (from 4.2 to 4.3), while the workforce is aging, suggesting QAN may be having more difficulty attracting new employees.

Source: RBS (Equities) Australia Limited, 18 January 2011

6.5 Identify strategically important performance measures

To demonstrate whether a strategy has been implemented by management and that it is capable of producing the outcomes expected, it is necessary to measure and communicate the quality of performance over a reporting period. To achieve this, management should identify KPIs that will allow measurement of performance against strategy and ensure the robustness of the systems used to collect the financial and non-financial information underlying the KPIs.

From a practical standpoint, identifying the link between the business strategy (strategic objectives and business model), value and prospects, and identifying the KPIs by which progress towards the strategy can be measured, is one of the most difficult areas of sustainability reporting. Once made, the link will need to be explained carefully to the capital markets as well as other key stakeholders. This education process can take time. The following extract from Qantas' 2010 Data Book provides an example of how performance can be communicated.

Diagram 12: Fuel efficiency strategies – Qantas

Fuel efficiency strategies	Anticipated annual energy savings	Actual annual energy savings achieved (FY10)
Investment in new generation fuel efficient aircraft	997,602 tonnes of aviation fuel (at FY20)	
Reduction in Auxiliary Power Unit (APU) fuel use		2,126 tonnes of aviation fuel
Aircraft weight reductions		6,379 tonnes of aviation fuel
Flight planning optimisation		4,460 tonnes of aviation fuel

Sustainable aviation fuel (SAF)

Over the medium term, it is imperative for aviation to secure a sustainable alternative to traditional jet fuel. The Group is committed to facilitating the development of a renewable alternative jet fuel industry in Australia.

During 2009/10, the Group joined with a handful of airlines and other aviation industry participants from around the world as part of the Sustainable Aviation Fuel Users Group (SAFUG) to develop cleaner jet fuels. The Group led the launch of a world-first 'roadmap' study in conjunction with the Australian and New Zealand group of SAFUG to identify barriers and ways of removing them on the way to a sustainable aviation fuel industry.

The Group has completed a review of the sustainable aviation fuel market globally and has identified technologies and organisations with whom a closer collaboration may be warranted. The Group has significant scale and aims to use that scale to motivate the development of a SAF supply chain. Government will be critical as activity levels increase.

Source: 2010 Qantas Data Book

6.6 Collect robust data

The trustworthiness, transparency and credibility of the financial and non-financial information underlying all KPIs, including KPIs measuring ESG matters, is a critical factor in maintaining access to well priced capital.

The quality of a company's information gathering and integrity protocols is imperative in maintaining the trust of the capital markets (as well as providing robust management information). Businesses should have processes in place to ensure that the quality of their ESG KPIs are explained. This includes controls to ensure that a balanced story is reported (balancing both positive and negative information as relevant), and the collection of information is undertaken in a structured and complete way across all business units and geographic locations.

There are a number of weaknesses in the systems and processes typically used to support sustainability reporting in the current environment, as set out below.

Diagram 13: Common weaknesses in systems and processes

Governance  Weak Strong	• Lack of documented environmental reporting • Lack of ownership of function, data and systems • No effective approval process for significant judgements • Finance and environment departments work in silos • No clear governance structure around energy and emissions reporting • Limited involvement or scope from internal audit
Requirements  Weak Strong	• General understanding of the need to report however the specifics not clearly articulated • Potential for inconsistent interpretation across an organisation • Siloed knowledge and understanding of requirements
Process & Controls  Weak Strong	• Ineffective controls • Manual and inefficient processes • IT system outside company wide system/ERP, often reliant on Excel. • Emissions reporting processes not designed to withstand audit scrutiny
Accountabilities  Weak Strong	• Lack of clear accountabilities and responsibilities • Gaps in experience / skills in emissions reporting • Poor communication between central and sites • Not viewed as important as financial data • Policy and procedures not yet developed • Quality assurance missing
Evidence  Weak Strong	• Lack of documentation to support methodologies used, assumptions applied and business decisions made • Lack of process documentation (e.g. maintenance of meters) • Lack of audit trails

Source: KPMG

If the capital markets are to place more reliance on ESG matters, and if trust is to be maintained, sustainability reporting systems should be calibrated to perform with the same level of detail and rigour as financial reporting systems. Businesses should specifically evaluate and re-assess the quality of systems and controls that underpin *all* and *any* information reported in the public domain, including ESG matters. Internal control over all external reporting should be a key focus for CFOs.

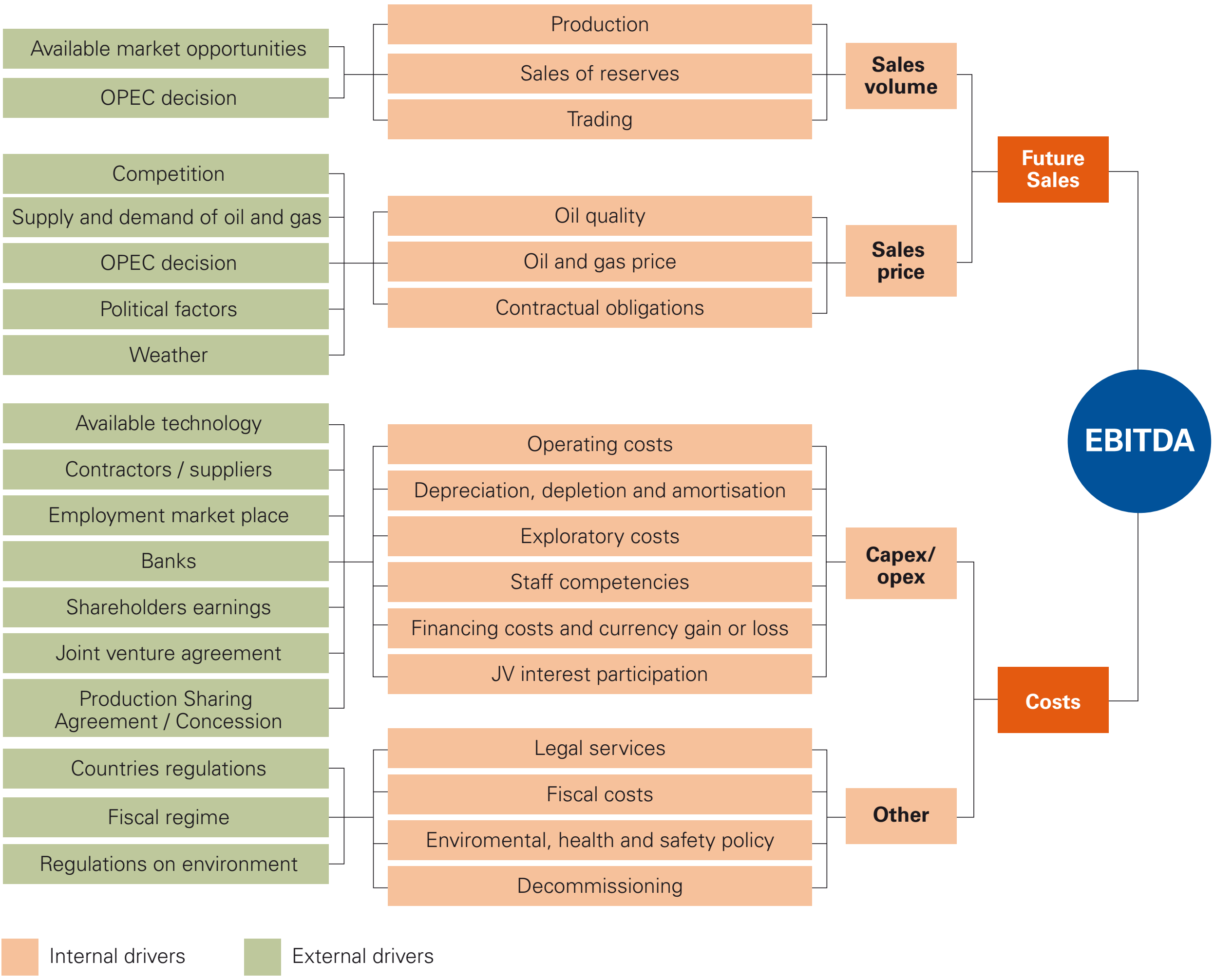
6.7 Provide insights into ESG performance prospects

Insights should be provided to identify and explain the following:

- The targets for ESG KPIs set by management and how these targets demonstrate success in terms of the overall strategy.
- An explanation of the company's performance against targets for each ESG KPI identified, including the reasons for under or over performance and the processes in place or to be put in place to improve performance over future periods.
- The impact of ESG performance on overall financial performance, and insights into its expected impact in future years (for example, how performance has either reduced costs or improved revenues, and how risks have been identified and managed).

Diagram 14 shows how KPIs measured and reported can be clearly linked to projected cash flow impacts, providing capital markets with a clear link between KPIs and expected future performance.

Diagram 14: A simplified diagram for a company in the energy and natural resources sector



Source: KPMG

6.8 Communicate ESG performance in an understandable, consistent manner

To be relevant to the capital markets, sustainability reports need to clearly describe how the business competes and the part ESG factors play in the competitive process. They also need to describe how ESG performance contributes to the generation of financial returns over the short, medium and longer term, as well as how senior management thinks about strategy. Reports need to show how the business measures and oversees the execution of the strategy, including the manner in which the ESG matters reported translate into, or drive, financial performance. This, in turn will develop the capital markets' trust in management's ability to execute its strategy.

An enhanced sustainability report will contain a balance of short, medium and longer term perspectives on the role that ESG matters play in business performance.

7 Ten steps to enhance sustainability reporting – now

The following 10 steps should significantly enhance sustainability reporting and in doing so improve the overall quality of your business reporting and its utility to the capital markets.

1 **Identify key ESG matters –** Identify the key ESG matters that affect overall business performance and analyse how these matters are incorporated into your strategy. What risks and opportunities affect your business performance? What changes are likely to affect your industry in the medium term? Consider the objectives and interests of key stakeholder groups and adopt a longer-term view of your business, industry and overall economy.

2 **Understand your stakeholders –** Hold regular meetings with key capital markets stakeholders to understand their current knowledge of how ESG issues are dealt with in your business strategy. Learn how these stakeholders build ESG performance into their capital allocation decisions. Identify the information they regard as most important in reaching capital allocation decisions.

3 **Evaluate the quality of externally reported data –** Ensure that the systems, processes and controls that capture and record information underlying ESG KPIs are robust.

4 **Measure ESG performance –** Identify relevant key KPIs that measure performance in ESG management and its benchmarking against strategy.

5 **Ensure ESG management data is robust –** Develop internal reporting systems that are sufficiently robust to deliver accurate and timely financial and non-financial information that underlie ESG KPIs. Integrate it into financial reporting systems where possible. Consider independent review/audit of data and processes in the formative reporting stages.

6 **Drive performance, including ESG, through the organisation –** Embed performance against key ESG criteria into management remuneration practices.

7 **Report only what is material –** Consider splitting sustainability reporting into those items that are material to the capital markets and the ESG items of broader interest to other key stakeholders.

8 **Educate key stakeholders on ESG matters –** Make the link between ESG matters and overall performance absolutely clear.

9 **Communicate with transparency and consistency –** Ensure that the link between the strategy, KPIs selected and overall business performance is described clearly and transparently. Do not assume the capital markets (or anyone else) understand the linkage.

10 **Maintain trust and credibility at all times –** Balanced reporting is essential, even if it is bad news.

References

i See Better Business Reporting: Enhancing Financial Reporting, KPMG in Australia, 2010, available at kpmg.com.au

ii Based on KPMG research at March 2011

iii http://www.westpac.com.au/about-westpac/sustainability-and-community/performance-reporting/stakeholder-impact-reports/

iv The Sustainability Reporting Journey, Australian Council of Super Investors July 2010

v KPMG research ASX100 as at 7 Dec 2010

vi Green Winners: The performance of sustainability-focused companies during the financial crisis, A.T. Kearney, 2009

vii SAM Sustainability Investing, media release, April 14, 2010, Zurich

viii Corporate Environmental Management and Credit Risk – Rob Bauer and Daniel Hann, Maastricht University 30 June 2010

ix Does the Stock Market Fully Value Intangible? Employees satisfaction and Equity Prices – Alex Edmans, University of Pennsylvania 26 June 2010

x Voluntary Non-financial Disclosures and the Cost of Equity Capital: The Case of Corporate Social Responsibility Reporting, Dhaliwal, Zhen li, Tsang and Yang, Feb 2009

About the authors

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Related publications

This is the third in a series of Better Business Reporting publications covering developments in financial reporting, management commentary, sustainability reporting and automated business reporting.

KPMG publications that may also be of interest include:

- *The Journey to Better Business Reporting,* KPMG in Australia, 2010
- *Better Business Reporting: Enhancing Financial Reporting,* KPMG in Australia, 2010
- *Enhancing management commentary – review of practice,* KPMG in Australia, 2011
- *Underlying profits survey,* KPMG in Australia, 2011

For further information, or to obtain copies of these publications, please contact your KPMG adviser or one of the professionals listed at the back of this publication.

Contact us

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