

Sustainability and Private Equity & Principal Investors Practices

More than values: The value-based sustainability reporting that investors want

Nonfinancial reports helped stimulate the growth of sustainable investing. Now investors are questioning current reporting practices—and calling for changes that executives and board members must understand.

by Sara Bernow, Jonathan Godsall, Bryce Klempner, and Charlotte Merten



As evidence mounts that the financial performance of companies corresponds to how well they contend with environmental, social, governance (ESG), and other nonfinancial matters, more investors are seeking to determine whether executives are running their businesses with such issues in mind. When companies report on ESG-related activities, they have largely continued to address the diverse interests of their many stakeholders—a long-standing practice that involves compiling extensive sustainability reports and filling out stacks of questionnaires. Despite all that effort, a recent McKinsey survey uncovered something that should concern corporate executives and board members: investors say they cannot readily use companies' sustainability disclosures to inform investment decisions and advice accurately.¹

What's unusual and challenging about sustainability-focused investment analysis is that companies' sustainability disclosures needn't conform to shared standards in the way their financial disclosures must. Years of effort by standard-setting groups have produced nearly a dozen major reporting frameworks and standards, which businesses have discretion to apply as they see fit (see sidebar "A short glossary of sustainability-reporting terms"). Investors must therefore reconcile corporate sustainability disclosures as best they can before trying to draw comparisons among companies.

Corporate executives and investors alike recognize that sustainability reporting could improve in some respects. One advance that executives and investors strongly support, according to our survey, is reducing the number of standards for sustainability reporting. Many executive respondents said they believe this would aid their efforts to manage sustainability impacts and respond to sustainability-related trends, such as climate change and water scarcity. And many investors said they expect greater standardization

of sustainability reports to help them allocate capital and engage companies more effectively. While these findings might not surprise readers involved with sustainable investing or sustainability reporting, it was striking to learn that investors also support legal mandates requiring companies to issue sustainability reports (Exhibit 1). In this article, we offer executives, directors, and investors a look at how sustainability reporting has evolved, what further changes investors say they want, and how investors can bring about those changes.

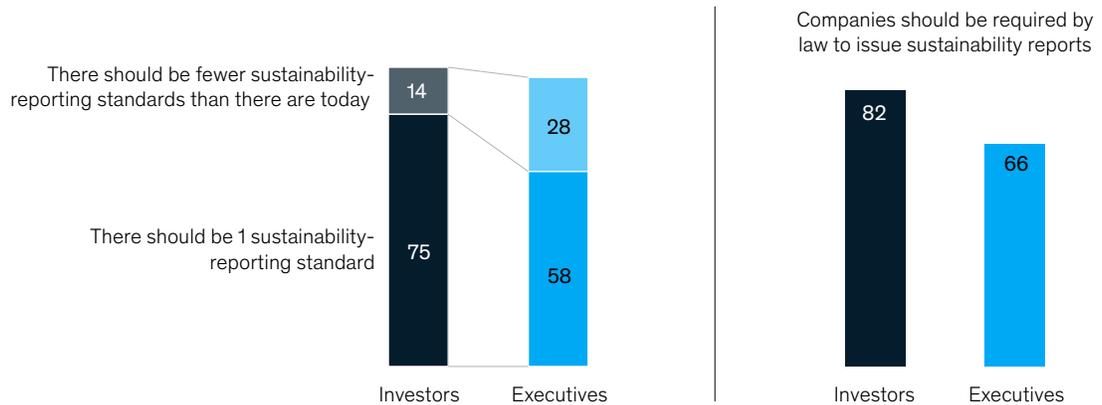
Reporting today: Externality focused and inconsistent, yet informative

The current practice of sustainability reporting developed in the 1990s as civil-society groups, governments, and other constituencies called on companies to account for their impact on nature and on the communities where they operate. A milestone was passed in 2000, when the Global Reporting Initiative (GRI) published its first sustainability-reporting guidelines. The following year, the World Business Council for Sustainable Development and the World Resources Institute released the Greenhouse Gas Protocol. The same period also saw the creation of voluntary initiatives, such as the UN Global Compact and the Carbon Disclosure Project (now CDP), encouraging corporations to disclose information on sustainability. Since the financial crisis, additional frameworks and standards have emerged to help companies and their investors develop a greater understanding of the risks and benefits of ESG and nonfinancial factors. For example, the International Integrated Reporting Council (IIRC) advocates integration of financial and nonfinancial reports, the Sustainability Accounting Standards Board (SASB) identifies material sustainability factors across industries, and the Embankment Project for Inclusive Capitalism assembles investors and companies to define a pragmatic set of metrics to measure and demonstrate long-term value to financial markets.

¹ For this research, we conducted a survey of 107 executives and investors, representing 50 companies, 27 asset managers, and 30 asset owners. The survey, carried out in January and February of 2019, covered Asia, Europe, and the United States. We also conducted interviews with 26 representatives of asset managers, asset owners, corporations, standard-setting organizations, nonprofit organizations, and academic institutions.

Investors and executives say that reducing the number of sustainability-reporting standards would be beneficial—and even that there should be legal mandates for reporting.

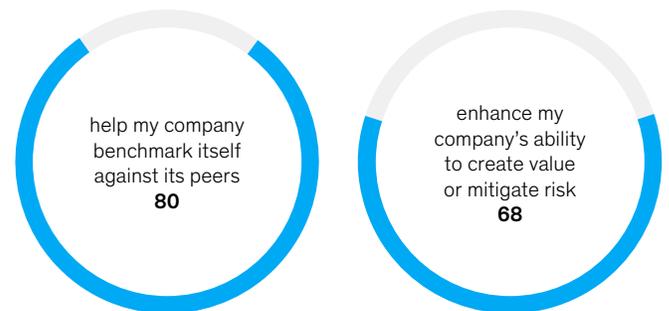
Respondents who agree with statement, %¹



% of investors who agree or strongly agree that more standardization of sustainability reporting would do the following¹:



% of executives who agree or strongly agree that more standardization of sustainability reporting would do the following¹:



¹ Respondents who answered "agree" or "strongly agree." For investors, n = 57; for executives, n = 50.

Source: McKinsey Sustainability Reporting Survey

Given the proliferation of reporting frameworks and standards, companies have had to decide for themselves which ones to apply. These frameworks and standards allow businesses considerable freedom to choose their sustainability disclosures. Many companies select their disclosures by consulting members of stakeholder groups—consumers, local communities, employees, governments, and investors, among others—about which externalities, or impacts, matter most to them and then tallying the stakeholders' interests in some way. More recently, stakeholders have asked for

increased disclosure about how companies address opportunities and risks related to sustainability trends, such as climate change and water scarcity, which can meaningfully affect a company's assets, operations, and reputation.

The scope and depth of these disclosures differ considerably as a result of the subjective choices companies make about their approaches to sustainability reporting: which frameworks and standards to follow, which stakeholders to address, and which information to make public. According

A short glossary of sustainability-reporting terms

In this article, we use the following terms for certain elements of sustainability reporting:

- **Sustainability disclosure.** This disclosure is an item of qualitative or quantitative information about a company's performance on a topic not addressed by standard financial and operational disclosures. Sustainability disclosures ordinarily relate to environmental, social, and governance matters, including companies' sustainability impacts and responses to external sustainability trends. These disclosures sometimes encompass other topics, too, such as HR and intellectual property.
- **Sustainability report.** This report is a document containing a set of sustainability disclosures from an organization for a period of time. It

can be a stand-alone document or a component of the annual report.

- **Sustainability-reporting requirement.** This requirement is a mandate from an authority (such as a regulator, a stock exchange, or a civil-society group) about a sustainability report's content and nature. Some requirements apply to all companies in a given jurisdiction—for example, Directive 2014/95/EU of the European Parliament and the European Council, requiring some large companies to issue nonfinancial disclosures. Others, such as the UN Global Compact, apply only to companies that have voluntarily pledged to abide by them.
- **Sustainability-reporting framework.** This framework is a set of guidelines for determining what

topics and disclosures a sustainability report should cover. The International Integrated Reporting Framework, published by the International Integrated Reporting Council (IIRC), is one example.

- **Sustainability-reporting standard.** This standard is a set of specifications for measuring and disseminating sustainability disclosures. Examples include the Global Reporting Initiative's GRI Standards and the 77 industry-specific standards published by the Sustainability Accounting Standards Board.

to the executives and investors we surveyed, the diversity of these disclosures is a defining feature of sustainability reporting as we know it—and a source of difficulty, as we explain in the following section of this article.

Nevertheless, 30-odd years of sustainability reporting have produced a trove of useful data. Stakeholders can use this information to track the relative sustainability performance of companies from year to year. By aggregating data from many companies, stakeholders can not only discern patterns and trends in companies' responses

to sustainability issues but compare and rank businesses as well.

Analysts in academia, government, and the private sector have also used these sustainability disclosures to examine the link between sustainability performance and financial performance. A substantial body of research shows that companies that manage sustainability issues well achieve superior financial results.² (Researchers have shown only that these two phenomena are correlated, not that effective sustainability management leads to better financial outcomes.)

² Alexander Bassen, Timo Busch, and Gunnar Friede, "ESG and financial performance: Aggregated evidence from more than 2000 empirical studies," *Journal of Sustainable Finance & Investment*, 2015, Volume 5, Issue 4, p. 210–33; Robert G. Eccles, Ioannis Ioannou, and George Serafeim, "The impact of corporate sustainability on organizational processes and performance," *Management Science*, 2014, Volume 60, Issue 11, pp. 2835–57; Gordon L. Clark, Andreas Feiner, and Michael Viehs, *From the stockholder to the stakeholder: How sustainability can drive financial outperformance*, a joint report from Arabesque and University of Oxford, March 2015, insights.arabesque.com; "Sustainability: The future of investing," BlackRock, February 1, 2019, [blackrock.com](https://www.blackrock.com).

Investors want companies to provide more sustainability disclosures that are material to financial performance.

Investors and asset owners appear to be taking note of corporate sustainability disclosures and adapting their investment strategies accordingly. The Global Sustainable Investment Alliance has found that the quantity of global assets managed according to sustainable-investment strategies more than doubled from 2012 to 2018, rising from \$13.3 trillion to \$30.7 trillion.³ BlackRock reports that assets in sustainable mutual funds and exchange-traded funds in Europe and the United States increased by more than 67 percent from 2013 to 2019 and now amount to \$760 billion.⁴ And research by Morgan Stanley indicates that a majority of large asset owners are integrating sustainability factors into their investment processes. Many of those asset owners started to do so only during the four years before the survey.⁵

What investors want: Financial materiality, consistency, and reliability

With so much capital at stake, investors have begun to question prevailing sustainability-reporting practices. The shortcomings investors now highlight have existed for some time but were mostly acceptable to early sustainable investors and the diverse civil-society stakeholders that used to be the primary readers of sustainability reports. But now that more asset owners and asset managers are making investment and engagement decisions with sustainability in mind, a louder call has gone out for sustainability disclosures that meet the following three criteria.

Financial materiality

Investors acknowledge that their expectations for sustainability disclosures have shifted. As the head of responsible investing at a large global pension fund remarked, “The early days of sustainable investing were values based: How can our investing live up to our values? Now, it is *value*-based: How does sustainability add value to our investments?”

From our interviews and survey results, it is apparent that investors want companies to provide more sustainability disclosures that are material to financial performance. According to a senior sustainable-investing officer at one top 20 asset manager, “Corporations do not provide systematic data on one-third of the sustainability factors [that we consider] material.” This could change as more companies issue reports in line with the sector-specific standards that SASB created in consultation with industry experts and investors.

Government authorities and civil-society organizations also appear to be coming around to investors' views about the material connection between a company's handling of sustainability factors and its financial performance. The European Union's 2014 directive on nonfinancial reporting and the Financial Stability Board's creation of the Task Force on Climate-related Financial Disclosures in 2015 are two signals that financial regulators realize sustainability-related activities can materially affect the financial standing of companies and should be reported accordingly.

³ *Global Sustainable Investment Review 2012 and Global Sustainable Investment Review 2018*, Global Sustainable Investment Alliance, gsi-alliance.org.

⁴ “Sustainability: The future of investing,” BlackRock, February 1, 2019, blackrock.com.

⁵ “Sustainable signals: Asset owners embrace sustainability,” Morgan Stanley, June 18, 2018, morganstanley.com.

Consistency

With so many reporting frameworks and guidelines to choose from, and so many potential stakeholder interests to address, companies rarely make sustainability disclosures that can be compared as neatly as their financial disclosures can. This circumstance makes the job of investors more difficult, as they indicated in response to our survey (Exhibit 2). As the head of sustainable investing at a major asset manager explained, “We have positions in over 4,500 companies. Unless [sustainability information] is comparable, hard data, it is of little use to us.”

Inconsistencies among sustainability disclosures, which arise through no fault of the companies producing them, can also create problems for the many investors that obtain sustainability data from third-party services rather than individual sustainability reports. These services use different methods to estimate missing information, so there are discrepancies among data sets. Some services normalize sustainability information, replacing actual performance data (such as measurements

of greenhouse-gas emissions) with performance scores calculated by methods the services don't reveal. Research shows a low level of correlation among the data providers' ratings of performance on the same sustainability factor.⁶

Similarly, proprietary indexes and rankings of sustainable companies, which some asset managers use to construct index-fund portfolios, can also diverge greatly. It is not unusual for a company to be rated a top sustainability performer by one index and a poor performer by another.⁷ And some data services fail to include sustainability data companies have disclosed.⁸

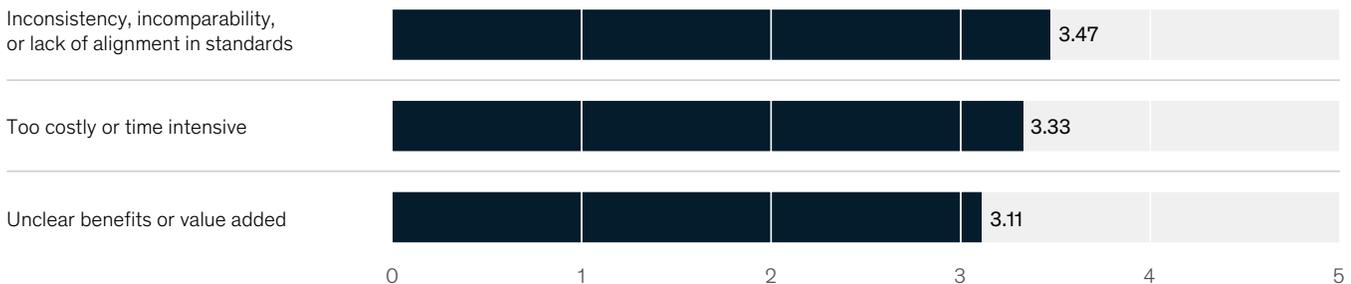
Reliability

As the head of responsible investing for one of the world's five largest pension funds put it, “Many companies do not have the systems in place to collect quality data for [sustainability] reporting.” For certain tangible sustainability factors, such as greenhouse-gas emissions, performance-measurement systems are generally well

Exhibit 2

Investors report that the main shortcomings of current sustainability-reporting practices are inconsistency, incomparability, and lack of alignment in standards.

Top challenges associated with current sustainability-reporting practices,¹ mean rating on 1–5 scale, where 5 is most challenging



¹n = 57.

Source: McKinsey Sustainability Reporting Survey

⁶ Gregor Dorfleitner, Gerhard Halbritter, and Mai Nguyen, “Measuring the level and risk of corporate responsibility—an empirical comparison of different ESG rating approaches,” *Journal of Asset Management*, 2015, Volume 16, Issue 7, pp. 450–66. The correlation between ratings of the same performance factor is typically less than 0.6 and can fall to as low as 0.05. By comparison, credit ratings are highly correlated (0.9).

⁷ James Mackintosh, “Is Tesla or Exxon more sustainable? It depends whom you ask,” *Wall Street Journal*, September 17, 2018, wsj.com.

⁸ “Sustainability: The future of investing,” BlackRock, February 1, 2019, blackrock.com.

established. For other factors, such as corporate culture, human capital, and diversity and inclusion, clear ways to gauge performance are more elusive.

Investors also harbor doubts about corporate sustainability disclosures because few of them undergo third-party audits. Nearly all the investors we surveyed—97 percent—said that sustainability disclosures should be audited in some way, and 67 percent said that sustainability audits should be as rigorous as financial audits (Exhibit 3).

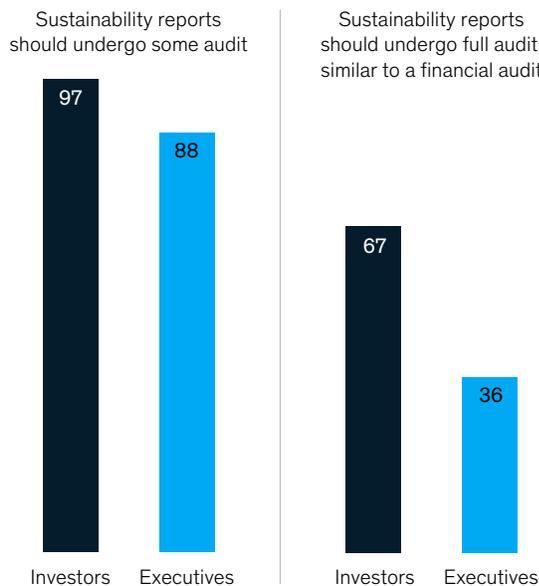
Refining the practice of sustainability reporting

In our survey and interviews, one priority for improving sustainability reporting stood out: ironing out the differences among reporting frameworks

Exhibit 3

More investors believe that sustainability reports should be audited and that the audits should be full audits, similar to financial ones.

Respondents who agree with statement, %¹



¹ Respondents who answered “agree” or “strongly agree.” For investors, n = 57; for executives, n = 50.

Source: McKinsey Sustainability Reporting Survey

and standards. When we asked survey respondents to assess the challenges of sustainability reporting, executives and investors both rated “inconsistency, incomparability, or lack of alignment in standards” as the most significant challenge. A majority of respondents to our survey—67 percent—said there should be only one standard, and an additional 21 percent said there should be fewer than exist now.

The investors and executives who participated in our research also described several benefits of making reporting frameworks and standards more uniform. Investors expect greater uniformity to help companies disclose more consistent, financially material data, thereby enabling investors to save time on research and analysis and to arrive at better investment decisions. Some efficiency gains would accrue as third-party data providers begin aggregating sustainability information as consistent as the information they get from corporate financial statements.

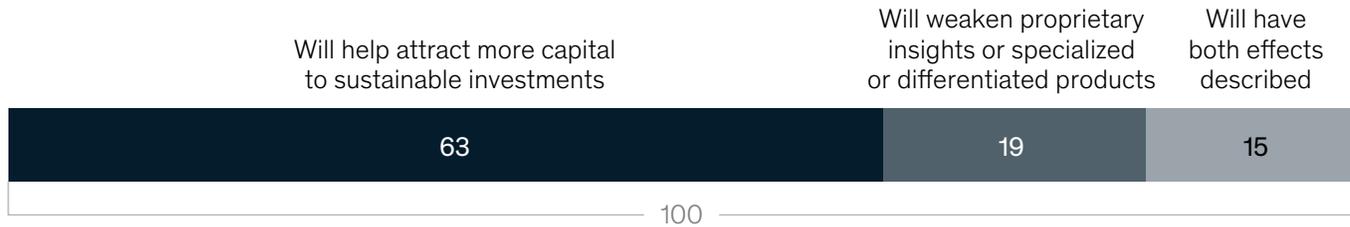
Most of the investors we surveyed—63 percent—also said they believe that greater standardization will attract more capital to sustainable-investment strategies. However, about one-fifth of the surveyed investors said that uniform reporting standards would level the playing field, diminishing their opportunities to develop proprietary research insights or investment products (Exhibit 4).

Executives made clear, in our conversations, that they devote excessive effort and expense to answering numerous specialized requests for what is essentially the same information, such as greenhouse-gas emissions data that must be tabulated in different ways to conform to different standards.

This kind of burden would be lessened if the providers of reporting frameworks and standards combined or rationalized their rules and thereby reduced the number of major frameworks and standards to one or two. Companies could then use the same disclosures to fulfill the reporting demands of multiple authorities. (They could still develop additional sustainability disclosures if they chose to address stakeholder

Many investors believe that harmonized sustainability-reporting standards will attract more capital to sustainable investors, though some express concern about losing an edge.

Investors who agree with statement about effect of harmonized standards, % of respondents¹



Note: Figures may not sum to 100%, because of rounding.
¹ Respondents who answered "agree" or "strongly agree"; n = 57.

Source: McKinsey Sustainability Reporting Survey

queries or concerns that the main mechanism didn't cover.) Establishing one or two reporting standards would also simplify the task of auditing sustainability disclosures, making it more economical for companies to have their reports independently verified.

How investors can help effect change

Reducing the number of reporting frameworks and standards will probably involve several more years of effort by businesses, investors, and standard-setting organizations—which have begun to identify gaps and redundancies among disclosures—and by other stakeholders, such as civil-society groups and regulators. As it is, many investors avoid participating in standard-setting efforts. Some we interviewed said they distance themselves because they feel that standard setting should address their needs as a matter of course. Yet some standard setters told us they assume that investors can readily obtain the sustainability information they value and therefore focus on the interests of other stakeholders.

Our conversations lead us to believe that there's some truth to both viewpoints. Yet our survey findings and interviews also suggest that investors could make valuable contributions to standard-setting efforts if they chose to increase their

participation. Active investors are likelier to do so, since they pay more attention than index investors to the sustainability disclosures of individual companies. Until investors clarify which sustainability disclosures they want and help to rationalize frameworks and standards, sustainability reports might continue to deliver less material information than they would like.

Investors can do several other things to make better use of the sustainability-related information companies now make available. First, they can articulate the sustainability disclosures that matter most for their investment decisions and convey these interests to businesses. Going a step further, more investors could engage companies (through direct dialogue and shareholder voting) about their approach to managing sustainability issues.

More investors could also adopt the still-uncommon practice of collecting and analyzing data from sources other than corporate sustainability reports and disclosures. Some investors have developed algorithms that automatically gather nonfinancial data from public sources (such as government databases of health and safety incidents or websites where people post comments about their employers) and scan these data for patterns that relate meaningfully to corporate financial performance.

As the market for sustainable investments expands, more investors are taking a keen interest in sustainability reports from companies. Yet the information these investors find seldom meets their expectations. From an investor's standpoint, sustainability disclosures tend to be loosely related

to financial performance, difficult to compare from one company to another, and less than reliable. Investors who take part in efforts to improve sustainability-reporting practices could gain an edge over their more detached peers. Executives and board members should stay attuned to these efforts, and even participate in them, to maintain their companies' standing with shareholders.

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