Executive Summary
April 19-20, 2016

Consultation of the Practice Group on Corporate Governance Codes and Standards

Too much and for too long, we seemed to have surrendered personal excellence and community values in the mere accumulation of material things.

Our Gross National Product, now, is over $800 billion dollars a year, but that Gross National Product... counts air pollution and cigarette advertising, and ambulances to clear our highways of carnage. It counts special locks for our doors and the jails for the people who break them. It counts the destruction of the redwood and the loss of our natural wonder in chaotic sprawl. It counts napalm and counts nuclear warheads and armored cars for the police to fight the riots in our cities. It counts... the television programs which glorify violence in order to sell toys to our children.

Yet the gross national product does not allow for the health of our children, the quality of their education or the joy of their play. It does not include the beauty of our poetry or the strength of our marriages, the intelligence of our public debate or the integrity of our public officials. It measures neither our wit nor our courage, neither our wisdom nor our learning, neither our compassion nor our devotion to our country, it measures everything in short, except that which makes life worthwhile.

Robert Kennedy, Remarks made at the University of Kansas, 1968

The above quote is offered as a preface to this executive summary in order to suggest that the generation of material wealth, whether measured as GDP or shareholder value, is not a perfect indicator of value. Not only does it miss a significant part of what is important in our lives but, arguably, what is essential. While GDP and shareholder value are useful indicators, the goal of sustainability and sustainability reporting is to go beyond financial indicators and develop a more profound understanding of how policy and corporations can contribute to the quality of human life.

1 John F. Kennedy Presidential Library and Museum website: http://goo.gl/RJpAc3
Introduction
Sustainability issues have increasingly come to the forefront of the public mind because of climate change, environmental degradation and the increasing awareness that our usual energy sources are finite. IFC finds that its donor partners and clients increasingly demand a response to the problems posed by the sustainability challenge.

On April 19-20 the IFC conducted a stakeholder consultation to help it inform the direction of its Practice Group on Corporate Governance Codes and Standards with respect to sustainability issues and sustainability reporting. The key question to resolve was how to integrate sustainability issues into the Practice Group’s work on corporate governance.

During the course of the April meeting the variety of different responses to the sustainability challenge, were repeatedly referred to as an “alphabet soup”. For those not familiar with the term, alphabet soup is a children’s dish made with letters made of pasta, which has become a metaphor for a confusing mixture of things. The executive summary seeks to go beyond a repetition of what was said to a synthesis of some of the thinking around the key themes.

Meeting structure and content
The first day of the meeting focused on corporate governance standards and codes and how corporate governance frameworks can accommodate sustainability issues. The agenda considered the views of:

1. Standards setters
2. Investors
3. The private sector
4. Regulators and stock exchanges

The second day of the meeting covered three aspects of corporate reporting:

1. Reporting on strategy
2. Governance reporting
3. Sustainability reporting

The focus of the second day was to discuss emerging trends in corporate reporting to meet the new needs of information users and how reporting can promote the goals of sustainability.

The Executive Summary is structured according to these larger themes. For meeting participants interested in detailed background information, the meeting agenda, transcripts, presentations, and written contributions are all available from Ralitza Germanova (rgermanova@ifc.org) at the IFC and can be downloaded at http://www.ifc.org/wps/wcm/connect/news_ext_content/ifc_external_corporate_site/news+and+events/practice+group+meeting+in+vienna+highlights+changes+in+global+esg+landscape+june+2016
Summary of the main issues

Corporate governance and sustainability
Finding a common language

There is strong agreement on the need for sustainability
Participants at the April meeting represented a wide variety of institutions, each with a different perspective on the relationship between corporate governance and sustainability. There was, nevertheless, an important commonality in view.

Most would agree with the sentiments of Robert Kennedy’s quote at the beginning of this note. Few would take the purist’s view that market economies automatically optimize the human condition and provide the highest standard of living on an equitable basis. The view of the “invisible hand” as both inexorable and infallible as espoused by Milton Friedman and Leonard Read’s in “I Pencil” is not commonly held.

Rather, the need for action in support of sustainability is increasingly viewed as one of the defining issues and challenges of our time. Sustainability is now the subject of international accords and presidential elections. In today’s age, globalization, airplane travel, and access to information make the world appear both smaller and its capacity to sustain human activity more limited. Climate change, pollution and access to land, water, energy and food resources are now real concerns for most people.

Since the corporation is the main generator of wealth (and positive and negative externalities) in society, the issue of the relationship between corporate governance and sustainability is a logical object of attention for sustainability advocates.

Views differ on how corporate governance should support sustainability
On the other hand, how to proceed from the recognition of the importance of sustainability issues to a plan of action is uncertain—especially as it regards the relationship between corporate governance and sustainability. Opinions tend to diverge quickly. Some see sustainability as a desire to make better and more successful companies. Others see it as an exercise in involving the private sector in sustainable development—making money work for positive societal change. Others wonder whether it’s too much to put the burden of solving social problems on shareholders, especially when their stewardship track record isn’t actually that good.

Traditional investors, executives and board members tend to see corporate governance as serving the interests of the corporation and its shareholders (while taking account of stakeholder interests). Sustainability advocates, on the other hand, tend to view the corporation as having an obligation to society. They may see the corporation’s as subject to a “social license to operate” which suggests that the corporation be formally accountable to society through its board and governance structures.

A different understanding of words and concepts confuses the discussion
These differences are not just a matter of linguistic rectitude. Governance and sustainability advocates were describe as coming from different worlds. The lack of a common vocabulary stymies the discussion.
• Even the concept of “sustainability” is understood in different ways. From a financial perspective, a sustainable enterprise is simply an enterprise that operates as a going concern under no immediate threat of liquidation. This implies that sustainability is a positive cash flow and profitability. The perspective of a sustainability analyst would include additional criteria such as environmental and social impacts.

• Some concepts such as “value creation” have been adopted from business lingo and used in a different way. Stock analysts will likely agree that value creation is the creation of shareholder value through the growth and profitability of the enterprise. A sustainability analyst would likely view value creation as protecting the environment, preserving employment, or contributing to the cultural life of a community.

• “Integrated reporting” can be defined as a concise communication on an organization’s strategy, its governance, its approach to value creation, its performance and prospects. Others view integrated reporting as simply combining ES and G indicators into one report. The Integrated Reporting <IR> website suggests that integrated reporting is designed first and foremost to serve businesses by helping them think holistically. Better environmental and social performance under integrated reporting may thus be only an incidental outcome.

• “Non-financial disclosure” is often equated with sustainability reporting. Yet, the term is used in the securities regulatory community to mean textual disclosures that accompany securities offerings and listings. It could be an MD&A, a description of significant shareholders, or a change in a rating by a rating agency. But, it does not necessarily mean social or environmental disclosure.

• The concept of “materiality” in disclosure is both a useful threshold and a stumbling block. Most corporate governance codes use it to mean information that could influence a buy/hold/sell decision in the equities markets. Materiality thresholds are designed to limit demands of companies by focusing on what is relevant. Unfortunately, a comparatively small oil spill may be immaterial from an accounting perspective while a community suffering from its consequences would likely take a different view.

Finally, codes and standards are being interpreted differently. The board chapter of the G20/OECD Principles of Corporate Governance says that the board “…should take into account the interests of stakeholders”. This is interpreted among sustainability advocates as meaning that the board should act in stakeholders’ interests. A narrow reading of the Principles only requires the board consider the positions of stakeholders while acting in the interest of the company and its shareholders. In summary, a better understanding of how concepts are used by different interest groups will surely encourage a more fruitful dialogue.

Is there an “elephant in the room”? The phrase is an idiom for an obvious truth that is going unaddressed. A possible elephant in the room is the extent to which shareholder objectives conflict with sustainability. Governance standards and codes are principally devoted to maximizing shareholder value and the return to the corporation. E and S standards and codes aim at broader societal outcomes. The implication for the Practice Group is that “integrating” ES&G standards into a single code may prove challenging. An attempt to do so would likely frustrate the expectations of both governance and sustainability advocates.
Some suggest that there is no trade-off between financial returns and societal impact. But, in practice, there are cases where financial returns and societal impact conflict. For example, investment in automation is designed to reduce labor and costs and will, by definition, have a negative impact on employment. Businesses often argue against sustainability rules because they place them at a competitive disadvantage with companies operating in more lenient jurisdictions. Most major companies are now well-versed in jurisdictional arbitrage to avoid the costs of progressive legislation.²

This conflict plays out at board level. The G20/OECD Principles maintain that the fiduciary duties of the board are to the company and its shareholders. They suggest that boards consider the impact that stakeholders have on the corporation but propose no fiduciary duty to stakeholder or any obligation to act in their interests. Under this view, stakeholders are protected by individual contracts and general law (labor, environmental, etc.) outside of the corporate governance framework.

It is possible to overstate this conflict. Clearly, corporations do act responsibly and do take societal interests into account (mainly to protect the value of their franchise). And, companies generally have systems in place to ensure compliance with both hard and soft law. However, insufficient thought may have been given to the conditions that provide incentives for profit maximization versus the pursuit of broader societal objectives.³

Standards

*There is a proliferation of standards and codes*

One of the questions raised by IFC is whether additional work might be required in developing codes and standards for sustainability in the context of corporate governance.

Standards, codes, laws and other guidance on sustainability and sustainability disclosure are plentiful. Presentations were made on the work of the Global Reporting Initiative, The European Commission, the International Integrated Reporting Council and the OECD. Some organizations such as the OECD have multiple standards.⁴ The UNCTAD standards were mentioned as an important reference point for governance disclosure.⁵

Some of these standards have become generally accepted international standards. The G20/OECD Principles are the global reference point for corporate governance while IFRS is the accepted global reference point for financial reporting.⁶ On the other hand, there is no single generally accepted standard for sustainability governance or sustainability disclosure. One reason may be that sustainability

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² Taking advantage of differences between competing legal jurisdictions. A contemporary example is the use of “tax inversions” by corporations to reduce their tax burdens where the resulting tax savings come at the expense of local stakeholders.

³ In contrast, it has been suggested that acting responsibly or in a sustainable manner bestows competitive advantages to companies. While it is undeniable that responsible business benefits corporations, positive or optimal social outcomes are not inevitable. Game theory (in particular the so-called prisoner’s dilemma) suggest that individual interests subvert the maximization of benefits for the group.

⁴ The G20/OECD Principles of Corporate Governance and the OECD Guidelines for Multinational Enterprises both deal with stakeholder issues.


⁶ IFRS require significant amounts of reporting on corporate governance-related issues such as risks, systems to manage reporting and risks, related-party transactions and so on.
encompasses a wide variety of fields, and that different standards respond to different users with different goals.

Overall, there does not appear to be a need for new standards. There may, however, be a need to provide guidance to companies and boards on how to integrate sustainability and stakeholder issues into their governance practices and into national governance codes. Though some organizations such as CERES\(^7\) and the ICGN provide guidance on how boards should respond to sustainability issues, there does not appear to be any authoritative guidance to this effect for the emerging market clients of IFC.

*There is duplication between some standards and codes*

The proliferation of standards and codes has resulted in some overlap between them. One can now find numerous standards that deal with the role of boards, remuneration, sustainability disclosure, how to disclose strategy and so on. Some codes and standards encroach upon the rules set by securities exchange regulators. The result is that corporations have to navigate between varieties of expectations. Though difficult, it would be desirable to have a more consistent approach and methodology to ESG for the sake of both companies and investors. At a minimum, any institution contemplating the development or expansion of a norm should first inform itself thoroughly on the content of the many existing codes and standards in order to avoid unnecessary duplication.

*Comparability between companies is difficult when there are multiple standards*

The proliferation of reporting standards makes comparability difficult. One reason is that different standards respond to different user’s needs. Comparability is also difficult because sustainability covers a wide variety of outcomes (environment, social responsibility, ethical practices). Another reason is that many standards are designed to be flexible in order to better reflect to the specificities of the company. Flexibility comes at the cost of comparability.

Comparability is achievable where meaningful indicators can be identified and quantified (such as carbon emissions) but is hard when measuring intangible values such as human capital or corporate culture. Furthermore, unlike financial reporting which focuses on a single indicator of profitability for all companies, sustainability issues differ between sectors. Though comparability remains desirable, it is likely to remain an elusive goal. Different standards based on area of sustainability and based on economic sector will likely persist.

**Investors**

*Investors are the biggest users of corporate reports*

Traditionally, the main users of corporate reports are lenders, equity investors and securities markets regulators.\(^8\) All three have traditionally focused on financial reports to inform their decision making though an increasing number of investors are concerned with sustainability with a few basing their investment strategies mainly on sustainability issues. Presentations were heard from three financial institutions (Universities Superannuation Scheme, Triodos Bank and the CDC Group) each of whom

\(^7\) Coalition for Environmentally Responsible Economies (CERES), View from the Top: How Corporate Boards can Engage on Sustainability Performance, [http://goo.gl/pavYKe](http://goo.gl/pavYKe).

\(^8\) The public, the press, academia, and government are also users of financial reports with NGOs a key driver of demand for sustainability reports.
integrate sustainability into their investment approach and their voting, and ICGN which has developed a stewardship code to guide its members.9

Investors are not a homogeneous bunch
Investors using “technical analysis” buy and sell equities based on algorithms that predict market movements. They tend to take a short-term view and are generally uninterested in sustainability data. “Fundamental investors” make decisions based on their assessment of the intrinsic value of corporations. They will use a form of discounted cash flow analysis to value companies. Their analysis is forward-looking, sometimes longer term, and will take into account a range of information to inform their decisions. E S and G indicators are important to them when they provide insight into future cash flows (e.g. potential payments for environmental damage, a class action suit) or influence the likelihood (risk/discount factor) associated with a future cash flow.

Investors can be a powerful influence on corporate behavior
Sustainability advocates hope that investors will exert pressure to effect positive societal change. The example of BP shareholders squelching planned awards for executives in the wake of poor share performance was cited.10 Yet, the Stakeholder Consultation was hardly over when 96% of Exxon and Chevron investors rejected resolutions by environmental activists to curtail new oil field development.11 This suggests that the great preponderance of investors remain motivated principally by cash flow. Investor support for sustainability goals should thus not be a foregone conclusion. Some investors confidentially acknowledge their sustainability departments are there mainly to assuage activist NGOs.

The population of investors committed to sustainability remains limited
This lack of interest in sustainability was lamented. Yet, the lukewarm response can be explained by how investors use sustainability data in their valuation models, the incentives under which investors operate, and their fiduciary duties. Investors do put pressure on companies to pursue societal goals when such practices impact investor interests. But, in the end, their incentive is to capture returns for themselves and shareholders. In contrast, there is little or no return for advocating in favor of a broader societal good. In fact, fiduciary duties would seem to prohibit investors from pursuing such issues as poverty alleviation, or job creation, or from divesting companies or sectors based on moral considerations alone.

The private sector
Sustainability advocates are keen to demonstrate that companies will benefit
Better reporting is expected to benefit companies and not just outsiders. The expectation is that private companies will help drive reform, and disclosure is seen as providing the main incentive. New approaches such to disclosure such as integrated reporting are designed to provide a more profound, holistic view of the company and, at the same time, enhance its strategy and internal decision making. Some companies are enthusiastically taking up the reporting challenge as a way of potentially unlocking

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9 ICGN [https://www.icgn.org/] members have hundreds of billions of dollars under management in all major and emerging markets in the world.

10 Remuneration can be considered a pure corporate governance issue and not a sustainability issue because it deals with traditional agency problems that arise when an agent makes decisions that go against the interests of a principal.

competitive advantage. Others view sustainability from a risk management perspective. Finally, some companies simply wish to respond to stakeholder requests for information and do well in disclosure rankings.

There are concerns regarding the costs and the utility of sustainability reporting
The reporting and disclosure burdens placed on companies seem to creep inexorably higher. Calls for information may respond to genuine policy concerns. However, the costs and administrative burdens, the actual impact of disclosures are rarely considered by standard setters. The administrative burdens are particularly important for small and medium-sized enterprises who may not have the resources to comply with exhaustive disclosure requirements.

Concerns were also expressed that the volume of disclosure may not, in fact, be of benefit to users. Reports are becoming longer and more complicated but more data points does not necessarily lead to the creation of useful information. Furthermore, excessive demands for reports may also lead to the box-ticking and compliance approach that everyone seems to want to avoid. There are also some indications that some of the additional disclosures are not even being used—even by sustainability advocates.

Traditionally, the concept of materiality has been used to determine what has utility and what does not. From a financial reporting perspective, information that would likely influence a buy/sell/hold decision is considered material. Expanded definitions of materiality open the door to far greater disclosure. Yet, more information is not necessarily better information. Standard setters should demonstrate the utility of the requirements they seek to impose. Both sustainability advocates and companies need to understand the reason for reporting and be convinced that they lead to real outcomes.

Boards are limited by their fiduciary duties
The integration of corporate governance with environmental and social objectives reflects an effort to get governance structures, in particular boards, to act in the interest of sustainability. Yet, acting sustainably can conflict with a board’s fiduciary duties. Board members are required under company law to act in the interest of shareholders and the company unless instructed to do otherwise by law (e.g. labor, environmental, safety, consumer protection, competition, etc.). To alter this would require a profound reinterpretation of a fundamental pillar of company law. At the board level, it would establish multiple and possibly conflicting objectives and accountabilities that would likely be difficult to reconcile.

Boards and voluntary codes may not be the best vehicles to drive sustainability
A broader concern is whether companies should become the tools of government policy. Government has the role of providing the legal framework within which companies operate and should legislate when legislation is needed. Furthermore, it is not certain that important societal goals should be left in the hands of companies, and board members whose training, experience and personal interests have probably never been directed at achieving important public policy goals.

A related concern regards voluntary versus mandatory approaches. To illustrate, the current administration in the United States has admonished companies for conducting so-called “tax inversions” to shelter their income overseas. It found that appeals to conscience did not work and eventually chose to pursue a legal response. Though voluntary and mandatory approaches are not mutually exclusive, if a
sustainability issue is of overriding concern, it may be more appropriate to pass legislation rather than influencing choices indirectly through soft law and a voluntary governance framework.

Regulators and stock exchanges
Increasing numbers of regulators are interested in sustainability and ES&G and disclosure
Regulators are increasingly considering sustainability issues and developing reporting requirements. Successful regulatory approaches were described as ones that were incremental and left flexibility to companies. Market-led approaches that allow for feedback from companies and make subsequent adjustments seem to work best.

Stock exchanges are driving sustainability disclosure in emerging markets
Stock exchanges are actively promoting sustainability and helping to increase ES&G transparency among listed companies. Increased sustainability disclosure has led to the creation of sustainability stock indices. Stock exchanges are not typically regulators. Most stock exchanges are privately-owned membership organizations or listed corporations operating under regulatory oversight even if some may have some enforcement functions. Unlike regulators, stock exchanges worry about excessively stringent rules for fear of chasing listings away.

Stock exchanges favor “comply or explain” disclosure
Stock exchanges typically require companies to disclose ES&G information on a comply or explain basis. Sustainability disclosure is, thus, mandatory while actual compliance is not. Stock exchange requirements can yield high disclosure rates with compliance of 97% reported in Denmark. On the other hand, comply or explain has limitations particularly in emerging markets where law is often taken much more seriously than voluntary codes.

Some countries have found that a more directive approach works better.
Experience in Malaysia has led to a more directive but, nevertheless, adapted approach. Rather than disclosing their compliance with a sustainability standard, companies were required to disclose what they thought were their material economic, environment and social risks and opportunities and describe why they thought they were material and how these risks and opportunities were linked to strategy. The resulting disclosures are more adapted to the circumstances of the individual company. Mandatory and voluntary approaches are not mutually exclusive; both can help corporations contribute to sustainability.

Exchanges often accompany ES&G disclosure requirements with assistance for companies and investors
Such disclosure requires knowledge and experience. It was repeatedly noted that ES&G disclosure initially meet with resistance, improve over time and are eventually embraced. Stock exchanges report that they accompany new requirements with manuals, toolkits and training to guide both companies and investors. IFC may wish to support the provision of such guidance.

Emerging markets are different
The pitfalls of transposing the rules and frameworks of highly developed markets into an emerging market environment are well understood. The requirement to disclose ES&G in Denmark may result in a 97% disclosure, but companies elsewhere may still be uncertain whether they should disclose a financial statement at all. Priorities will need to be set. Emerging markets may need to focus on achieving the
basics of timely and reliable financial disclosure first and then pursue a measured introduction of ES&G disclosure. In principle, compliance with IFRS would be a significant step forward since they already call for the disclosure of material risks (including environmental and social risks), related party transactions, remuneration and basic governance information within financial statements. Such disclosure would, of course, be subject to accounting definitions of materiality, but would likely be a good start.

Disclosure
How disclosure works (or doesn’t)

For regulators, disclosure is a substitute for substantive (merit-based) regulation
Rather than directly verifying compliance with rules, regulators require disclosure which permits the markets and the public to examine companies and hold them accountable. The capacity of disclosure to positively influence corporate behavior was most famously described by US Supreme Court Justice Louis Brandeis: “Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” Disclosure-based regulation is now the basis of securities markets regulation worldwide.

Disclosure-based regulation is generally accepted as a more practical alternative to merit-based regulation since regulators typically lack the resources to effectively monitor large numbers of companies and since markets are generally more effective in monitoring than regulators. The intended results are: better investor protection; a reduction in the cost of capital by reducing information risk; better management of enterprises; greater economic efficiency and capacity to generate value; and better function of civil society. Sustainability advocates wish to harness this powerful tool to influence corporations in favor of sustainability.

Over recent years sustainability reporting has become mainstream. KPMG reports that only 35% of the world’s 250 largest companies had corporate responsibility disclosure in 1999 while 92% did in 2015. Sustainability reporting is now a widespread practice. What is driving the momentum is greater demand and the expectation that sustainability information will enable investors and other stakeholders to take a more comprehensive view of corporations’ performance, value and long-term prospects.

There are significant challenges to making disclosure work
While its potential is enormous, a number of pre-requisites need to be in place for a disclosure-based regime to work. Three broad components are needed: 1) standards, regulations and a defined process to provide users with sufficient and useful information; 2) users of information that have an interest in outcomes (typically analysts and investors but also an active press and interested public); and 3) capacity of information users to react and impose consequences (usually through buying or selling of shares or through shareholder activism). Disclosure is generally maintained by an industry of professionals to develop standards and implement them. In the case of financial reporting, this is a highly-qualified accounting and audit profession

Not all of these factors will be equally present in emerging markets. The absence of institutional investors may limit the demand for information. Many emerging market enterprises are significantly smaller than their cousins in highly developed financial markets and have not have either the financial resources or human capacity to produce quality disclosures. The public sector institutions that write the rules, such as securities exchange commissions and stock exchanges, may be young and inexperienced.
The accounting and audit profession (and other providers of reporting-related services) may just be emerging. Perhaps the greatest stumbling block is that attitudes towards transparency are far less accepting.

**Reporting on strategy**

Business people use “strategy” to set the organization’s topmost goal in its marketplace and describe how to achieve it. Strategy is generally distinguished from “tactics” which describe how a company utilizes its resources to achieve sub-goals that support the strategy.

**Strategy disclosure needs to carefully balance concerns regarding competitive information**

Companies are protective of their business strategies which they see as being competitive. On the other hand, information on a company’s strategy and its capacity for implementation is what interests the markets most. Regulators have been considering how to strike the appropriate balance between the needs of the markets and the need for business confidentiality. The challenge for regulators is defining the minimum. The challenge for companies, who are traditionally reticent to reveal the details of their strategy, may be to reconsider what information is truly competitive.

The question of strategy in the context of sustainability is if and how sustainability goals might fit into the strategy setting process. Most companies have no specific strategy for achieving sustainability and, where they do have sustainability goals, these are largely disconnected from their commercial strategy.

**Sustainability influences strategy through its impact on profitability**

One way is for companies to consider sustainability as an integral part of the business planning process. This is, in part, the philosophy behind triple bottom line and integrated reporting. Each suggests that the corporation needs to see itself holistically and integrate a broader set of elements into its strategy setting process. However, both stop short of making sustainability the ultimate goal of strategy. Boards are typically viewed as being limited by their fiduciary duties to the company and its shareholders in their capacity to set strategy with the express aim of achieving sustainability objectives.

Another way of integrating sustainability concerns into the traditional strategy setting processes is to consider it a risk. Risk and risk management have gained increasing prominence in the wake of recurrent crises. All companies have risks that need to be monitored and managed through governance mechanisms. The more traditional risks are currency, political, operational, legal risks and so on. The list of risks that companies consider is expanding to include the impact of sustainability issues on earnings (e.g. the costs of the damages related to the BP Deepwater Horizon oil spill and the cost of penalties and recalls related to the Volkswagen emissions scandal) and reputational risk (e.g. the presence of child labor in the supply chains of Apple, Samsung and many others).

**New ways need to be considered for how to integrate sustainability concerns into strategy**

Both approaches integrate sustainability into existing approaches to strategy which aim at achieving competitive advantages for the company and managing strategic risks. Neither proposes that boards act directly in the interest of sustainability or purely on moral grounds. As a consequence, more reflection is required on how boards can support the achievement of societal interest (other than simply ensuring compliance with extant law). One possibility may be to integrate sustainability into business strategy by requiring companies to favor the more sustainable alternative whenever the choice between two alternative strategies or decisions has otherwise equal outcomes. More research on how boards integrate sustainability into their strategy setting in practice may be useful.
Governance reporting

Beneficial ownership is the flavor of the moment

Beneficial ownership was largely considered a corporate governance backwater until the issue exploded on the world stage through the revelations of the Panama Papers. Disclosure of ownership has traditionally been regulated. But, it is still common practice to mask the ultimate beneficial owner of companies through intermediaries. There are now increasing calls for better rules to require the disclosure of ultimate beneficiaries. The G20/OECD Principles were recently updated to suggest that, at a minimum, the identity of the ultimate beneficial owner be obtainable through judicial process. On the other hand, though beneficial ownership is usually painted as an attempt to avoid taxes or to obscure wealth, there is a legitimate concern in some countries, in particular where distrust of government is high and where legal systems are underdeveloped, that knowledge of beneficial ownership will result in attempts to disproportionate legitimate owners.

Related-party transaction disclosure is well established but does not respond well to governance concerns

Related party transactions disclosure is well established. Related party transaction disclosure is set under IAS 24 of International Financial Reporting Standards. IAS 24 has equivalents in many national accounting standards including US GAAP. Related party transaction disclosure requirements set through accounting standards have a number of advantages. They are well understood, are mandatory and widely implemented as part of the regular reporting process, and would typically be audited.

There are, however, some gaps that limit their utility for the purpose of corporate governance. The first is limits posed by materiality. Some transactions may be immaterial and even trivial from the corporate perspective, but could pose fundamental problems of conflict of interest from a governance perspective. Furthermore, IAS 24 does not require disclosure of key information such as a related party transaction policy or the conflicts of interest of board members and executives. Other standards for transparency in related party transactions exist, however, the most prevalent, accounting standards, provide insufficient information for governance purposes.

Remuneration disclosure is widespread but, arguably, also misses the mark

Executive compensation disclosure is typically ruled by securities exchange regulation and is implemented to varying degrees in listed companies globally. Best practice suggests that disclosures should cover the base salary paid to executives, short and long-term incentive compensation, and benefits. The classic concerns, particularly in emerging countries where large differences in earnings between the rich and poor are politically inflammatory, are whether compensation should be disclosed individually or in the aggregate for a group of executives and the level of detail required. In some countries like the UK there is arguably too much information.

Yet, getting remuneration disclosure right remains a challenge everywhere. Some of the issues are: 1) the complexity of compensation packages; 2) the difficulty in determining costs (in particular for long-term share and option plans); 3) demonstrating that there is a link to performance; 4) uncertainty regarding whether incentive compensation really creates incentives; and 5) demonstrating that shareholders receive value for money. Finally, of course, is the issue of whether shareholders actually have any control.
Another issue is whether remuneration disclosure is aimed at solving the right problem. While eye-popping numbers always serve to draw attention, the focus of remuneration disclosure may be better directed towards the systems that regulate compensation practices: remuneration policies; the role of the board in reining in abusive pay practices; and how to ensure value for pay. These issues are preoccupying but not broadly acknowledged despite studies that show the correlation between performance and incentive pay to be minimal and the ability of pay to incentivize performance weak.

Sustainability reporting

The value proposition needs to be clearer

Sustainability reporting is really trying to promote more sustainable development and hold companies accountable. Yet, many people reject sustainability. One of the main criticisms is that sustainability is everything except focused on the essential (i.e. profits) and that it is by definition non-strategic. The discussion repeatedly circles back to the question of why sustainability disclosure is needed and the expected outcomes.

Different types of reporting aim at different outcomes

It was suggested that sustainability and corporate governance advocates come from different worlds. Traditional governance and financial reporting does not take sustainability issues into account except in an almost incidental manner through risk. On the other hand, sustainability reporting has not traditionally taken into account the interests of investors. Integrated reporting manages to bridge the gap. Integrated reporting is for all stakeholders even though its main purpose is to serve the company and investors by enhancing corporate decision making. Under the integrated reporting model sustainability reporting is useful even if one only cares about money.

Nothing will ever replace cash flow

It is important to acknowledge the importance of cash flow. If a company cannot keep its doors open, the lights on, and if it cannot meet its payroll, then no one cares about carbon emissions or human rights policies. The most important goals is to keep businesses running. At the same time, sustainability reporting provides crucial contextual information on the company’s impact on society. This information is important for the long-term viability of the economy, for the strength of societies, and for companies to produce real value.

Despite efforts to make sustainability reporting more relevant and effective, results are mixed

Though there are many users of sustainability information, disclosure is mainly aimed at the financial markets and investors. Some investors actively use sustainability information in their decision making but this far from the norm. Many find sustainability reporting disconnected from strategy and lament the lack of comparability between reports. The general population does not read sustainability reports and there is a fear that they are being produced mainly to meet demand from NGOs. Some disclosures are excessively long, boilerplate and difficult read. Greenwashing, where companies focus on PR rather than implementing sustainable practices, has become a problem and there are concerns that companies use it mainly as a marketing and public relations tool.

These challenges to the credibility of sustainability reporting need to be met. In this regard, sustainability reporting can take inspiration from the financial reporting play book. Financial reporting suffered from similar problem in its infancy but managed to overcome them through the gradual development of a conceptual framework for reporting. For sustainability reporting, the absence of a
conceptual framework means that the rules that make financial reporting useful (relevance, reliability, neutrality, timeliness, prudence, substance over form, completeness and so on), that provide the basic grammar for financial statements and that make them comparable and comprehensible worldwide are missing.

IFC Role

Disclosure of reliable, timely information that is readily accessible contributes to liquid and efficient markets by enabling investors to make investment decisions based on all the information that would be material to their decisions.

For 60 years the IFC has incubated businesses in the most destitute places, creating vehicles for private-sector economic development as a standard setter and a promoter of good international practice.

Today, as the IFC is looking to magnify its development impact, we see transparency and disclosure as an opportunity to shed the light on how our companies create economic and social development in emerging markets, in order to:

1. Increase investment opportunities
2. Lower risks and the cost of doing business
3. Provide access to global capital markets
4. Achieve economic and social development
5. Create more conducive environment for the adoption of policies that are oriented towards sustainable growth and demonstrate ESG leadership

Best-in-class disclosure and transparency can mitigate some inherent risk of investing in emerging and frontier markets, including weaker public institutions and governance, heightened social and environmental risk and smaller companies with controlling shareholders.

When paired with the IFC’s investment criteria and its corporate governance and sustainability standards, transparency and disclosure provides a complete model for investment vehicles that can attract existing and new investors looking to manage ESG risk, adapt to climate change and co-invest with public institutions to meet the SDGs.

Disclosure and transparency are critical elements of a robust corporate governance framework as they provide the basis for informed decision-making by shareholders, stakeholders and potential investors with respect to capital allocation, corporate transactions and financial performance monitoring.

Corporations are now under pressure to provide timely, consistent and accurate information to shareholders and the public regarding financial performance, liabilities, control and ownership, and ESG.

World Bank survey from June 2016, among 20 institutional investors covering $1.2 billion in assets under management, shows that quality of the financial reporting is their biggest concern in emerging markets. Boiler-plate and defensive reporting remain the main response of too many companies facing pressure from regulators and investors.
Currently IFC is developing two new tools that will help enhance transparency and disclosure in emerging markets:

**IFC Integrated ESG Progression Matrix** that incorporates key aspects of IFC’s Performance Standards on Environmental and Social Responsibility\(^\text{12}\) and IFC’s Corporate Governance Methodology\(^\text{13}\). The development of the Framework was initiated after a year-long stakeholder mapping and engagement over 2016 which identified a gap in integrating ESG in emerging markets. The ESG framework sets guiding principles for assessing company’s key ESG policies and provisions based on six parameters:

1. Commitment to ESG
2. Structure and Functioning of the Board of Directors
3. Control Environment (Internal control system, Internal Audit Function, Risk governance and Compliance)
4. Disclosure and Transparency
5. Treatment of Minority Shareholders
6. Stakeholder Engagement

It represents an opportunity to advance IFC’s strategic commitment to sustainable development by delivering increased operational efficiency to clients and enhance market practices. The Progression Matrix is expected to be tested in the beginning of 2017 both in our investment and advisory work.

It will be used as a basis for the development of Transparency and Disclosure Toolkit/Guidance and Codes of Best Practice, which enhance the incorporation of environment and social considerations (ESG Codes).

**Transparency and Disclosure Toolkit/Guidance**

**What is the purpose of the Toolkit?**

The Toolkit is designed to guide companies in emerging markets in the preparation of comprehensive and best-in-class annual reports that are appropriate for their size, organizational complexity and adapted to the context of operation, so it can provide decision useful information for investors and other stakeholders.

The Toolkit is organized around three main pillars: Strategy and Sustainability Management, Corporate Governance and Performance. For each, the toolkit provides a disclosure framework on what to report and how to report. The Toolkit is designed as a flexible framework for companies of different size, location and operational complexity. For relevant sections of the report, it suggests different levels of performance that can be reported, based on the IFC ESG Progression Matrix. The toolkit references and

\(^{12}\) IFC Environment and Social Performance Standards [http://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/sustainability+and+disclosure/environmental+social+governance/environmental+and+social+performance+standards+and+guidance+notes]

\(^{13}\) IFC Corporate Governance Methodology [http://www.ifc.org/wps/wcm/connect/topics_ext_content/ifc_external_corporate_site/ifc+cg/investment+services/corporate+governance+methodology]
integrates internationally recognized standards (GRI, IIRC, OECD, SASB, IFRS, etc.), legal requirements and best practices relevant to the preparation of a comprehensive annual report.

**What is the Toolkit aiming to achieve?**

The toolkit promotes an enhanced and integrated approach to corporate reporting, presenting strategic, sustainability and corporate governance information together with financial results to provide investors with a better understanding of how the company is likely to perform in the future. The document provides practical assistance to companies aspiring to enhance their disclosure, particularly on non-financial issues. It incorporates an account of how environmental and social issues impact the company’s strategy, risk profile and performance, how key risks and impacts are managed as part of the company’s corporate governance.

**Who will find this Toolkit useful?**

**Companies** - The Toolkit is designed to guide emerging market companies in the preparation of their annual reports.

**Investors and banks** - to support their valuation and credit analyses.

**Regulators** - to prepare reporting guidelines or regulation.

The Toolkit is written primarily for medium and large companies that have separated management from ownership, either because they are listed on an exchange or because they are privately-held but have outside investors. While the annual report targets primarily investors, it is also useful for other stakeholders.

**The toolkit is expected to be send for public review by March/April 2017.**

The Toolkit is part of the IFC’s larger effort in integrating environment, social and governance considerations in a common IFC’s ESG approach for its advisory and investment clients and wider emerging market leadership in standards.