

**Market failure:  
*the case for mandatory social and environmental reporting***

by Deborah Doane  
Head, Corporate Accountability, New Economics Foundation  
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### **Introduction**

So, the voluntary approach to social and environmental is working, is it? In that case, where are all the social reports?

Since the Prime Minister called for the top FTSE350 to report on their environmental impacts by December 2001, few have actually responded to the challenge. By late last year, less than one third of the FTSE 350 produced a substantive environmental report, and only a scant 24 reported that they would endeavour to do so in the near future.<sup>i</sup> The results of social reporting are even more worrisome.

As far back as November 2000, the New Economics Foundation raised the alarm bell – that only 35 of the FTSE 350 – (half the number of environmental reporters) – produced any form of social report at all. A year later, studies continue to confirm that the voluntary call to reporting on social issues is largely failing. Consultancy company ERM recently reviewed the use of social indicators by the FTSE100 and found that while 79 are publishing some social information on their website, only 16 companies use any quantitative performance data to back up their policy assertions. “Very few companies have begun to move beyond corporate gloss,” they confirmed.

There are varying ways of counting the number of reports and the different studies provide assorted information as to the number of actual reporters in the social and environmental arena.<sup>ii</sup> What is notable is that the overall picture presented by the various studies is the same – the market does not provide sufficient incentives for companies to report on their social and environmental impacts on a voluntary basis.

### **1. The myth of the business case**

The business case for continued voluntarism in reporting (and indeed the broader CSR agenda) arises from the premise that by managing and being transparent about social and environmental impacts, a company will better manage risk and ultimately perform better financially than those who fail to report. It is assumed that the market will bring enough pressure to bear by rewarding the good guys and punishing the others. Aside from the evidence that voluntarism has failed to deliver the goods, there are two core problems with this assumption.

First, market mechanisms rely on informed consumers. But the reality is that the perfectly informed ‘ethical consumer’ is non-existent. The Co-operative Bank report, *Who are the Ethical Consumers?* found that while 89 percent of British consumers are

concerned with social and ethical issues, only 18 percent reflect this in their purchasing decisions occasionally, while fewer than five percent, according to MORI, could be called 'Global Watchdogs' – people who make an active and informed choice in the majority of their purchasing decisions.<sup>iii</sup> And those ethical businesses that are rewarded by consumers tend to be in the niche end of their respective markets – Fair Trade or Green Energy, for example.<sup>iv</sup>

Second, and intimately linked to the first, is that the incentives for business are simply insufficient. Nowhere is this more striking than when we look at businesses who don't report on their social and environmental performance, but continue to have ongoing success, both with consumers and investors. The telecommunications and banking industries fall into this category. Amongst the top four banks in the UK, three provide limited environmental data, and only one has reference to social issues beyond basic philanthropic contributions. Yet these industries do have substantial sustainability impacts. To take the mobile phone industry as an example, the potential concern that phones and masts might have on human health is a growing concern, but not regularly reported on or considered by investors. In the case of banking, financial exclusion and who a bank lends to (i.e. indebted governments in the South) have a direct link to social and economic sustainability outputs.

While many companies, such as those in the extractive industries, may be excluded from niche-based SRI funds for not producing a report, they still have sufficient access to capital and a broad customer base by which to survive. Thus – they are rewarded by the market, not for doing well, but for doing poorly.

There is a wider strategic imperative, of course, for companies to adopt reporting and other CSR practices:

developing long-term markets; protecting natural assets; and ensuring an educated and diverse source of labour. But these incentives don't necessarily pay off in the 6 month to two-year time horizon that most businesses, through demands of the stock market, require.

Thus, the 'business case' cannot be expected to deliver when the short-term demands of the stock market provide perverse incentives for not addressing sustainability. Reporting is just one facet of this argument. Delivering on the broader sustainable development agenda through voluntary means seems a naïve ideal at best and a manipulated half-truth at worst, proffered only by those who want to avoid so-called "red-tape" where it is in their best interest.

## **2. Too many codes and standards**

The proliferation of codes and standards on CSR results in confusion for business surrounding what society's expectations are. Where there is no immediate business argument, such as risk to the brand, how can we expect business to report on or measure their impacts? For example, is it relevant for a company to report on human rights abuses in their supply chain when it hasn't been raised as a risk issue by a public campaign? Should companies be reporting on every payment they make to a host government to enable them to operate, if accounting rules don't require them to distinguish these from other costs? Why would spending on lobbying activities be relevant for corporate reporting if not required by law? Government institutions such as DEFRA and the DTI offer some guidance for companies, as do private organisations, such as BiTC or CSR Europe. But there are notable differences in the issues and how these are prioritised.

If a company is not already managing distinct social or environmental issues,

it is unlikely they will see the value of reporting on them. The Global Reporting Initiative (GRI) does offer a potential standard for reporting, but it remains entirely voluntary and the framework is such that companies can pick and choose which of the indicators they would like to report on. This makes it virtually impossible to compare and benchmark corporate social and environmental performance.

Business argues that this gives them the flexibility to ensure reporting is appropriate to each individual business. However, within particular sectors and for businesses of similar size, the expectations should remain consistent. "In some industry sectors the mismatch between what stakeholders want to know and what information companies are providing is acute".<sup>v</sup> Consumers, civil society and government should be able to benchmark performance in much the same way as they do for financial performance, and this can only come when indicators are universal within a sector.

### **3. Corporate spin**

The second concern is that business will adopt social and environmental reporting more for PR purposes than for legitimate risk-management reasons, which is a more ominous proposition than simple confusion. It implies that business has an active role in obfuscating information.

The ERM study which found 'corporate gloss' in social reports is supported by a number of other research findings. "As things stand, the most inadequate voluntary code can be hyped by the company concerned – while even excellent ones are difficult to defend against the critics." Voluntary codes can be manipulated for any desired outcome by the company concerned, while at the same time obscuring all means to see it as a legitimate accountability tool for stakeholders.

The acknowledgement that some corporate efforts amount to no more than 'corporate spin' is starting to emerge from within the business community. As an anonymous ex-BP consultant recently said, "stakeholder dialogue is a very subtle and intelligent management technique to evade criticism."

### **4. Lack of enforcement mechanisms**

Finally, the lack of enforcement mechanisms within the voluntary framework for reporting leads to tell-tale cracks in the business case debate. Voluntary codes rely on business to uphold them – there is no external means of enforcement, let alone redress. While some companies utilise the accounting sector to provide a statement of verification for the contents of a report, these loose statements do little to provide assurance that the report is adequate. For example, it is common practice for a verification statement to ignore what has not been included in the report.

The recent Enron debacle provides a strong argument against allowing the accountancy sector to manage the public interest with regards to financial information, let alone social and environmental accounting. More often than not, the latter reveals information that a company would rather keep hidden, from serious environmental hazards to labour standard violations. Consistent legal obligations can provide a more balanced and transparent means by which to exert fair and honest judgements.

### **5. The social case for mandatory reporting**

"The business of business is business". Milton Freedman's oft-referred to dogma is finding some strange bedfellows in those who are calling for mandatory reporting. The advocates of maintaining the voluntary regimes argue that business should be

expected to consider what is not necessarily in their immediate interest. While we can expect business to undertake open reporting of their social and environmental impacts if it is in their *business* interest to do so – and some are indeed rewarded for doing just that -- as we have seen, it is not always the case. Furthermore, what is in the interests of business is not necessarily compatible with the interests of society. Even Adam Smith, the original free-marketer, advocated on behalf of a strong government.

If the interests of business don't always align themselves with the interests of society, then what is the social case for regulating reporting? There is no need to debate whether or not companies have impacts on society beyond their own business: corporate impact on the environment, communities or individuals is already widely acknowledged. The debate is whether or not these impacts should be solely managed by the corporate sector.

Quite clearly, there is a legitimate role for government in this area. Governments have largely abdicated their responsibility by placing the onus for social issues in the hands of business, in spite of the fact that the primary responsibility for 'managing the commons' is firmly within the domain of the state. A problem with voluntary corporate responsibility regimes, including transparency, is that they lend themselves to overlook state responsibility in this area and leave the commons largely to manage themselves.<sup>vi</sup>

Government has a distinct responsibility to provide an adequate framework not only to protect citizens' rights, but to ensure that basic needs are met. In a market-based system, government must ensure that those who are excluded from the market have a leg-up; and that sufficient information is available to make

effective decisions. When things go awry, the government's responsibility is to protect citizens and consumers from harm. The environment, health or education are all public goods issues. Yet business is being asked to take an integral role in managing these issues without any enforced guidelines and certainly without laws.

It is now accepted that simply relying on trade to bring about social change is an unreasonable expectation. That companies have impacts beyond their borders is a further reason for strengthening the role of governments, particularly in the North, where the majority of international corporations are registered. Efforts to promote democracy on a global basis and to empower citizens' role in economic and social development will go unheeded if there is an ongoing reliance on weaker states in the South to uphold corporate behaviour within their borders.

In spite of the supposed awareness of these issues, we have a leadership vacuum at the government level. "Government and society must set the ethics agenda for business; the question is whether they are ready", note Andrew Mackenzie and David Rice also from BP.<sup>vii</sup>

At a minimum, local stakeholders must be provided with access to relevant information, which should ideally be followed up with opportunities to utilise that information. A mandatory reporting regime provides the anchor upon which government can base these efforts.

## **6. The business case for mandatory reporting**

While an in-depth study with full costing has yet to take place, there are some obvious arguments in favour of mandatory reporting, strictly from a business case perspective, rather than a public interest one.

- **Levelling the playing field.** If all businesses were to undertake reporting, the costs for doing so would not be a competitive decision. Arguably, some businesses who openly report might feel that they don't want their competitors to do so, as it would diminish their own competitive edge. But the distinctions would then emerge, not in terms of who is transparent, but how best a company is managing these issues. The 'free rider' who argues they are doing something for society would rightly be penalised by the market, and 'best in sector' would become more relevant with all comparable information on the table.
- **Reducing costs through limiting gloss.** Companies can spend anywhere from \$100,000 to \$1 million (USD) on a report.<sup>viii</sup> A bulk of these costs are often through production, rather than auditing costs. Yet the Co-operative Bank, best in class of the ethical reporters, spends only £30,000/year in auditing and verification costs. The report that they issue has replaced their annual glossy publication that accompanies financial accounts, while at the same time providing them with valuable benefits in equivalent advertising over the years, arising from information in the report – Paul Monaghan, from the Co-operative Bank says this has been independently estimated at anywhere from £100,000 to £1.1 million. For those who do report, they argue that it is in managing these issues through reporting more than the glossy output where they see the most benefit. Mandatory social and environmental reporting should see the reduction of costs by limiting spin through the production of high-cost PR reports, focusing business on the
- management issues at hand and including this information in the annual report to shareholders.
- **Simplifying processes.** Earlier this year, Nestlé expressed its growing annoyance with "questionnaire fatigue", noting that they have to respond to so many different requests for information to various groups about their social and environmental performance. Most of this, they argued, should be contained in one single report.<sup>ix</sup> By limiting bespoke reporting to investors and other stakeholders, mandatory reporting would establish a definable standard for business and minimise transaction costs.
- **Clarifying responsibilities.** Public affairs departments spend inordinate amounts of time and money trying to gauge what is expected of them by the public, consumers and governments. By pooling resources, through collaborations such as the GRI, these expectations can be more clearly defined, while reducing costs. Industry associations can also cut lobbying expenditure in this area.
- **'The stakeholder is always right'.** As we move from a consumer-based society to a 'stakeholder' based society, it is only right that companies take a small shift sideways and support the notion that the stakeholder is always right. Of course, business can't take a step in this direction if the market is failing and the incentives to do so are only limited. Mandatory reporting is the only way to encourage this shift.

## Conclusions – mandatory reporting and the market

The Company Law Review attempted to find a middle ground on the reporting regime, by including reference to social and environmental issues in the proposed Operating and Financial Review. But the OFR continues to rely on director's judgement about whether or not these issues are relevant to a company's operations.

A market cannot operate without adequate information. By leaving decisions on what is relevant performance in the hands of business distorts the decision-making process of the market. In fact, mandatory reporting will allow the market to operate more effectively – by making sure that relevant and transparent information is provided to all.

Regulation need not be cumbersome – it need only require firms to report on information that most large companies will already have access to. Civil regulators can and will do the rest.

The market hasn't delivered full social and environmental reporting by all companies, so we must now move to more proactive efforts. And government must take a lead. For business, mandatory reporting can reduce transaction costs, level the playing field, and help to define expectations of stakeholders. The benefits are obvious for society – providing a more informed citizen, ensuring that negative impacts can be mitigated through an open and transparent process, and to reward those businesses that are serious about sustainable development.

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## REFERENCES:

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- <sup>iii</sup> Roger Cowe and Simon Williams, *Who are the Ethical Consumers?* Co-operative Bank, 2000
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