Extra Financial Value Drivers

Sumantra Sen emphasises the role of extra-financial communication and its strategic importance in an organisation

India's Financial Markets — distinguished member of the global trillion-dollar club and one of the top 15 in terms of capitalisation — have played a significant part in the country's overall growth story. A ten-fold increase in the annual FDI flows from USD 2.2 billion in 2004 to about USD 27.3 billion in 2012 further demonstrates the investors' interest in recent times. Questions have been raised about the continuity of these trends especially in view of the present slow-down, but the broad consensus is that India is likely to retain its position as one of the leading destinations for investment.

There is, however, a word of caution. The domestic business community needs to be aware of the fact that, more than ever before, they are being tracked on much broader, extra financial parameters. Subsequent to the advent and extended consequences of the global financial crisis, the practice of integrating 'extra financial' information has been gaining attention amongst the expanding tribe of responsible investment community. The growing unanimity amongst the business and political intellectuals has further emboldened this drive to seek comprehensive disclosure on issues that are considered extra to financial concerns. Although not really new as a topic for debate, the last seven to eight years have seen the discussions around the role corporations play in the society and their engagement with other stakeholders shift to a new paradigm. In the world of global business as well as society in general, corporate sustainability and responsible strategies have emerged in recent years as prominent issues. This change clearly mirrors the shifting attitudes in meeting the expectations that society places upon the corporates.

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Extra financial information may combine a wide range of ESG (Environmental, Social and Governance) issues which are likely to have a short, medium and long-term effect on corporate performance. Extra-financial factors include, but are not limited to, corporate governance, human capital practices, innovation, intellectual property, customer contentment, climate change, natural resources management and reputational risk.

This set of concerns, that has conventionally been brought up only by the socially responsible investors are evidently getting mainstream with global investors, regulators and analysts. Close attention to these extra-financial factors is being paid as they are viewed as material to a company's performance. These issues that can have an effect on even reputable operations and prominent brands, have built a compelling business case for the investors to train focus on the extra financial issues in their holistic approach to risk management. International guidelines and recommended standards such as UN-backed Principles of Responsible Investment and Equator Principles lay the fundamentals of this responsible approach and are advancing in terms of adoption. Global investment community may not seek complete integration from India at this stage but may well be looking at some adherence to global standards in managing these issues. This is time for the corporates to set the course for sustainable growth, address the gaps in strategy and execution to further contribute to the making of an economic powerhouse.

Role of Strategic Financial Communications

In the financial world that transforms by the second, strategic communication practices need to stay a step ahead on diverse existing and upcoming issues that organisations may cope with, predominantly those that relate to their fiduciary duties and may have organisational impact. It must be able to strategically evaluate the various patterns of stock performance that the company may undergo as a result of a public disclosure or new regulations.

It is critical that all such material and credible information about the company is strategically disclosed to the broader investor and stakeholder community. The companies with successful disclosure practices understand that for their market capitalisation to reflect the longer-term value they aim at creating, they need to recognise the most useful actors and build effective communication channels with them. Corporate leaders and communication need to understand that any breakdown in the transfer of critical information may reflect on the quality of management and can give away signs of ambiguity.

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Due to the potential impact of legal liability claims emerging out of the extra financial issues and the resultant impact on the company's share price, financial communication has a pivotal role in managing them. The decision making by the investors as well as the analyst community is a customised and highly complex process. The motivations and perspectives of different participants in this decision making space may vary significantly. The asset owners and managers may differ in their priorities particularly with regard to extra-financial disclosure as compared to the analysts who are providers of research and independent analysis. The financial communication practice needs to be aware of these differences and build expertise in creating bespoke strategic communications around extra financials. The imperative point here is that mere communication of extra financials and their linkage with long-term value even for more prominent firms may just not be adequate. It is elemental for the winning firms to identify and engage with analysts that follow the company and inform them suitably. As the relationship between sustainability and investment performance plays out better in the long term, it has been observed that analysts, who have spent more years tracking a company or sector and have also gained broader awareness around the extra financial issues, are expected to see the value creation in the long run. As capital markets are more responsive to recommendations of more experienced analysts, the company's capital markets communication efforts of integrating extra-financials may be mainstreamed while briefing them.

Communicating Corporate Performance across Dimensions

In order to advance the dialogue on extra financial communication, companies need to shape up the kind of information that they would like to convey to the capital markets to ensure that they are adequately assessed as value generating elements in the process of the long-term evaluation. Therefore, the companies must comprehend the environmental, social and governance issues that are important to their business. Progressing and sincerely understanding the cause-and-effect linkages between extra financial issues and the financial metrics, is an essential stage of the process. As it is a new area, the disclosure and communication from companies to the stakeholders including investment community currently lack well-defined links between ESG and financial performance, and overall, how they link up to corporate strategy.

Further, the disclosures must include not only the data on past performance but also the forward-looking assessments. These assessments can include forecasts that clearly articulate how ESG factors are projected to affect cash flows over a period of time. Effectual Integration of this material information into financial and corporate performance will facilitate a better measurement of the companies' long-term capabilities. Who should deliver this critical information is also very relevant. Although the role of the IROs is increasingly acknowledged, many investors and analysts have indicated that direct engagement with the CEO or CFO is likely to influence their investment decisions or company analysis. Consequently, the straight guidance from the Top or Board level representatives, coupled with access to reliable reporting channels and reports should be helpful in mainstreaming extra financials as well.

Once the 'what' and 'who' segments are well defined and developed, the companies need to ascertain that the "how" is equally well executed, that is, effective communication channels have been deployed. There are attributes that are similar or dissimilar between investors and analysts, therefore, a robust communication strategy should act on these similarities and variances, applying several channels to target specific clusters of stakeholders. A critical thing about extra financial information is the extra rigour on quality disclosure not just quantity. Stakeholders need information that supports comparison and benchmarking around these parameters that have always posed a major challenge to conventional investment analysis.

Investors and many other stakeholders are already contributing to the global movement in improving the comparability of extra-financial information by joining industry-wide efforts. It is clear that companies would also benefit from participating in these large-scale efforts to enhance the comparability of extra-financial information – through development of standardised benchmarks and methodologies. In order to advance to the next stage of adoption, collaboration across multiple disciplines, sectors and standard setting organisations will be required to take it to the desired conclusion. One such effort that is gaining ground is Business Responsibility Reports (BRRs) by listed companies based on the National Voluntary Guidelines (NVGs) as recommended by the Ministry of Corporate Affairs (MCA). MCA, in July 2011, came out with the revised 'National Voluntary Guidelines on Social, Environmental and Economic Responsibilities of Business.' Comprising of nine Guidelines and 48 core elements, the NVGs provide a framework for responsible business action, which can be used by most of the segments of businesses. The drafting committee adopted an extensive consultative approach while developing the guidelines. Substantial inputs of various stakeholders — leading industry associations, experienced professionals, and other experts — are duly reflected in the final version. It also provides a section on reporting, to enable businesses to demonstrate adoption of these guidelines to stakeholders through reliable disclosures.

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Taking this disclosure initiative to another level, Securities & Exchange Board of India (SEBI) in a landmark decision in August 2012, mandated the inclusion of BRRs as part of the companies' annual reports. Initially, the requirement to include the reports on a "comply or explain" basis was made mandatory for the top 100 listed entities based on market capitalisation as on March 31, 2012. SEBI also indicated that more companies will be added into the scope in due course but also encouraged other listed entities to voluntarily disclose BR Reports. As some of the initial confusion settles down and the check-list mindset evolves into more spirited implementation, these reports may prove to be an influential source of extra-financial information. There may be further refinements that will come along but developing communication around such integrated reporting could bring significant benefits to reporting companies and stakeholders alike – especially in mainstreaming material extra-financial risks and opportunities.

To sum up, all the stakeholders are increasingly considering the corporate performance on financial and extra financial parameters for a well-rounded picture. Successful companies have already made the transition from the outdated financial modeling to more sophisticated and more sustainable partnership modeling that goes beyond a focus only on shareholder wealth. In the long term, the key differentiator between the companies that succeed and those that do not in this extra financial end game will be this complete engagement on such issues with all the stakeholders and, very importantly, the strategic communication of such objectives and milestones to the capital markets. ■

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