K C Chakrabarty: Non-financial reporting – what, why and how – Indian perspective

Address by Dr K C Chakrabarty, Deputy Governor of the Reserve Bank of India, at the National Conference on "Non-Financial Reporting and Risk Management for Financial Institutions in India", jointly organised by GIZ, SIDBI, Global Reporting Initiative (GRI), IIM Bangalore and NextGen, Mumbai, 6 June 2011.

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Mr Stefan Helming, Country Director, GIZ India, Mr Rakesh Rewari, DMD, SIDBI, Prof Rajeev Gowda, Chair, Centre for Public Policy, IIM-Bangalore, Ms Karin Ireton, Director, Group Sustainability Management, Standard Bank, Dr Aditi Haldar, Director, GRI, India, Ms Richa Bajpai- co founder NextGen, distinguished guests, ladies and gentlemen. It is a pleasure to be here at this National Conference on "Non-Financial Reporting and Risk Management for Financial Institutions in India" jointly organised by GIZ, SIDBI, Global Reporting Initiative (GRI), IIM Bangalore and NextGen. I congratulate the organisers for having chosen this theme as the importance of non-financial reporting in the overall assessment of a company's performance, its risk-return trade off is steadily gaining ground, both globally and in India. Conference such as these help to create awareness among the financial services industry players about the importance and benefits of Non-Financial Reporting (NFR).

What is sustainability reporting or non-financial reporting?

2. I have borrowed the topic of my address "Non-Financial reporting- What, Why and How- Indian Perspective" from the theme of one of the conference sessions. Let me start from what is reporting? Well, very broadly speaking, you would all agree that it is a structured way of presenting information about ones performance. If the information is financial in nature, such as financial position, profits, cash flows of an enterprise then it constitutes financial reporting which is beneficial to a wide range of users e.g. stakeholders, investors, regulators, etc. This then brings us to Non-Financial (NFR) or Sustainability Reporting (SR) which, as you are aware, is the practice of measuring, disclosing and being accountable to internal and external stakeholders for organisational performance towards the goal of sustainable and inclusive development. There has been a general perception that right from the time of Industrial Revolution, economic development has come at the cost of environment and has brought about large scale destruction of nature and growth process has not been inclusive. Due to the negative externalities of economic development, the practice of non-financial reporting started largely in response to pressure from non-governmental organisations (NGOs) and civic society, which claimed that many firms lacked social and environmental responsibility. It epitomises that a company's financial health is dependent on much more than the assets on its balance sheet and the movements on its profit and loss account. Non-financial reporting is an opportunity to communicate in an open and transparent way with stakeholders. In their non-financial reports, firms volunteer an overview of their environmental and social impact during the previous year. The information in non-financial reports contributes to building up a company's risk-return profile.

Why is it important?

3. To be able to truly appreciate the importance of non-financial reporting, we have to step back in time to recollect how the parameters for evaluation of corporate performance have been changing over the years. During the initial phases, when business was organized as sole proprietorship or partnership firms, profit was the dominant indictor of the

performance. Subsequently, with the formation of joint stock companies and the development of stock markets, corporate performance was judged by market capitalization, share price and certain financial ratios such as Earnings Per Share (EPS), Return on Equity (ROE), etc. Now in the 21st century, corporate performance will be judged by *corporate social responsibility* (CSR) whose disclosure will fall under non-financial reporting. One of the critical parameters to be evaluated in this context would be the value created by the firm for society and whether such value creation is going to be enduring in nature. While the foregoing is true for any corporate, as far as banks are concerned, since they are highly leveraged institutions dealing with public money and public confidence, there is a greater responsibility for value creation. As a result, non-financial reporting will be extremely important for financial institutions such as banks and its relevance is only going to increase in times to come. Just as financial reporting is not only concerned with returns but the risk-return trade-off, similarly, non-financial reporting is also about the risks that one creates in the society. I also want to draw a fine distinction between sustainability and CSR. While very often these terms are used inter-changeably, what normally goes in the name of CSR are few acts of philanthropy like donation, setting up educational facilities, health services, etc. and a part of the profit is used for that. But charity is not CSR; charity is not sustainability. Sustainability means business has to be undertaken in a sustainable and profitable manner, and not create undue pressure.

Having said that, sustainability reporting has become more relevant and important in today's context not only from social or environmental concerns, but because, globally, we have come to realize that our goal is not just growth and profits, but we are looking at inclusive growth. And, if the growth process is not equitable, it cannot be sustainable. If inclusive growth has to be a permanent agenda item in our growth process, then it has to be sustainable. Today, many of world's problems have been attributed to the lack on inclusive growth. I would like the participants in this Conference to debate on this how this inclusive growth agenda can be brought in Sustainability Reporting. Finally, reporting has to be credible. It must be audited. If we do not make credible reporting systems, then it would not be meaningful. I would like the forum to also debate on this aspect as to how do you improve the standards of non-financial reporting.

How sustainable reporting is to be done – reporting framework

4. Studies reveal that the structure of reporting has changed substantially over the years. Whereas in the 1990s, most reports focused on environmental indicators only, today, reports tend to be more comprehensive and bring together economic and social as well as environmental data, or triple line reporting. John Elkington coined the term "triple bottom line" to describe social, environmental and financial accounting, and his sustainable development think-tank, "SustainAbility", released its first survey benchmarking non-financial reporting. I would venture to say that, maybe, we can coin a new phrase "quadruple bottom line" reporting to explicitly include inclusive development. But, reporting frameworks keep evolving and one does not have to wait for some finality before starting to report.

5. Global Reporting Initiative (GRI) is a global initiative to standardize NFR which the institutions adopt and has become the de-facto standard internationally. GRI is a long-term, multi-stakeholder, international process whose mission is to develop and disseminate globally applicable Sustainability Reporting Guidelines. These Guidelines are for voluntary use by organizations for reporting on the economic, social and environmental dimensions of their activities, products and services. The aim of the Guidelines is to assist reporting organizations and their stakeholders in articulating and understanding contributions of the reporting organisations to sustainable development.

6. One of the most widely used frameworks for reporting on sustainability is the Global Reporting Initiative's G3 Guidelines. This framework has been used in nearly 7500 reports to report on sustainability worldwide and more than 100 GRI reports have been published by

Indian companies so far. These guidelines also include a sector supplement, which specially focuses on the financial services sector.

The drivers and levers behind NFR

7. When analysing the factors that influence NFR trends, it is instructive to differentiate between drivers and levers. To better understand the two concepts, it is helpful to consider the metaphor of a car. A lever is a mechanism employed to induce action indirectly, for example, by pressing the gas pedal. Drivers, on the other hand, are direct forces, such as the fuel that sets an engine in motion. The strategic management of brand and reputation seems by far the most significant driver behind NFR for institutions. Further, another driver behind NFR is stakeholder pressure on companies to become more transparent and accountable about their environment and social behaviour. Thus, it is not surprising that the most publicly criticized sectors, in particular chemicals and mining, should display the strongest growth in the use of NFR. Pressure from competitors, pressure from NGOs, responding to pressure from financial industry etc. seem to be the other drivers behind NFR.

8. The role of Governments/regulators in pushing NFR could be one of the most powerful levers but is also one of the most controversial aspects of international sustainability debates. While most of the private sector is opposed to active Government involvement, many in the NGO community and general public see mandatory reporting rules as the only way to turn NFR into mainstream practice.

Mandatory versus voluntary

9. In most parts of the world, NFR remains a voluntary practice. So far, France is the only country to enact specific legislation requiring publicly listed companies to produce non-financial reports covering economic, social as well as environmental dimensions. Various other countries mandate detailed reporting for specific industry sectors. Additionally, some stock exchanges like the South African Stock Exchange now make NFR a requirement for listed companies. A number of stakeholders have called for sustainability reporting to be a mandatory requirement aimed at increasing corporate accountability, the argument being that most companies will generally not report of their own accord or, when they do, such reporting will be incomplete and rarely material to stakeholder interests.

10. Critics to the mandatory approach to NFR maintain that government regulation is not needed in this area since:

- Other market-based drivers exist that provide sufficient incentives for firms to report.
- Pushing the regulatory track will lead to a host of diverse national NFR regimes, thereby making international comparisons of non-financial reports difficult (if not impossible) and adding significant regulatory burdens on companies that operate across national borders.
- The approach would not allow for the continuous updating and improvement of NFR frameworks since the practice of NFR is still relatively young and requirement of a legislative process to effect changes would result in long delays.
- Innovation in the area of NFR will be reduced. Innovation is likely to occur if companies push for higher benchmark standards in order to produce superior reports to those of their competition. In a mandatory framework, such completion is far less likely.

Advantages of NFR

11. There are multiple advantages to both report preparers and report readers. The advantages to the report preparers are:

- Tool for increased comparability and reduced cost of sustainability
- Brand and reputation enhancement
- Differentiation in the market place
- Protection from brand erosion due to action of suppliers or competitors
- Fosters innovations in order to make processes environment friendly.

Advantages to the report readers are:

- Useful benchmarking tool
- Corporate governance tool
- Avenue for long-term dialogue with reporting organisation.

To sum up:

- Corporates that focus on Sustainability Reporting outperform their peers in the long run and help in consolidating their market position
- In view of reliable correlation between business integrity and above average financial performance, NFR demonstrates ongoing business integrity and enhances investor and stakeholder confidence.
- Helps to acquire national and international listing and gain access to otherwise restricted markets
- Helps to attract finance through transparent relationship with credit providers, improve management systems and employee motivation and customer satisfaction.

Banks and financial institutions and NFR

12. Banking and finance institutions' immediate environmental and social impacts are relatively low because most of those impacts are delivered through the activities of other businesses that rely on financial institutions – the businesses in a loan or investment portfolio. But they have a paramount role in ensuring that businesses that borrow from them and depend on them for financing understand the risk their business may pose for society and follow a sustainable agenda. So, despite the relatively indirect nature of their environmental and social impacts, banks need to examine the effects of their lending and investment decisions. All business activities have some environmental and social impact that typically results from substandard environmental and social practices, including:

- over-use and wastage of natural resources
- environmental damage caused by continuing polluting activities
- persistent damage caused by past polluting practices
- damage caused by accidents and mishaps
- use of environmentally sensitive materials

13. All these impacts have ramifications to business. The risks that such impacts create can be legal, financial, and reputational, and banks themselves are increasingly accountable for the effects their portfolios have on the environment and society. The costs that can be incurred by a business operating without regard to environmental and social issues include:

- pollution clean up costs
- fines
- increased waste handling costs
- costs from damaged assets with reduced value
- legal claims
- regulatory delays
- reduced public regard, and reduced sales

14. The risks that often get transferred to financial institutions include:

- increased loan defaults
- decreased value of investment and loss of collateral due to decreased asset values
- liability for damages arising from negligent investment advice
- loss of reputation and standing as a result of association with polluting businesses.

Position in India

15. The level of sustainability reporting in India is in its infancy and still evolving. In India, there are various drivers behind the increase in dialogue, discussion and publication of sustainability reports – drivers that are somewhat different from other parts of the world. For example, pressure from the NGO sector is low in India when compared to other countries. Pressure originates rather from increasing involvement in the global business environment. Many companies issuing CSR corporate communications now actively report on the social dimension as well. One thing is clear however, and that is, we cannot sacrifice growth. If our society has to survive, then it has to achieve a double digit growth for the next several years. If we bring the environmental and social concerns at the cost of growth, then it will not be acceptable. What would change the balance is how we integrate these concerns keeping our overall inclusive growth agenda intact. It will make SR more palatable and acceptable in our context. In the Indian context, it is relevant to note that a beginning has been made by Yes Bank becoming a member of United Nations Environment Programme – Finance Initiative (UNEP FI), which is an initiative to promote the integration of environmental considerations into all aspects of the financial sector's operations and services. While SIDBI has released a report as per GRI Guidelines, a few Indian banks are beginning to consider reporting on their non-financial parameters. In other international initiatives for sustainable development, corporate social responsibility and non-financial reporting also, the involvement of our banks, financial institutions, etc. is peripheral or at a very nascent stage.

16. For institutions in India's financial and banking sector, one of the primary drivers of their involvement in activities in social and environmental spheres is their reputation and branding. This is fuelled by the fact that these institutions have high visibility in every business sector and industry. Moreover, in emerging markets such as India, financing projects that focus on clean production, good corporate governance and sustainable energy are being increasingly identified as potential business opportunities for financial institutions. Furthermore, many financial institutions are also actively publicising their philanthropic activities under the corporate social responsibility banner. All these initiatives point to the sector's move toward financial institutions banking on their brand and reputation, to make a difference in the community in which they operate as well as, in their new risk management strategies that reflect the socio-environmental aspects of their investments.

17. There are many reasons for this change in mindset. Foremost is the increasing globalization of business. As more Indian companies expand internationally and acquire interests overseas, whilst at the same time, there is a rapid increase in foreign investment in

Indian Corporates, demands on transparency from a more "global audience" have put pressure on Indian companies to start reporting on sustainability issues. Within India, there has also been a change in the mindset and attitudes of stakeholders on issues relating to environmental and social responsibility. Recently, government faced public protests and pressure to refuse entry to foreign ships that were brought to India for decommissioning, as they contained large amounts of asbestos and other harmful substances. While the general public opinion on sustainability issues is still evolving, companies taking the first steps can expect intense public scrutiny, which again highlights the need for transparent reporting on operations. Another significant push factor has been the role of government as a stakeholder. India has historically had stringent laws on labour, environment, health and safety. Over the past few years the government has become increasingly proactive in addressing enforcement. Intense media attention and scrutiny on corporate social responsibility has also led to companies taking more cognisance of their activities and engagement with stakeholders.

Reporting standards

18. While currently there are no officially recognized guidelines or reporting standards on sustainability reporting (by accounting or regulatory bodies), there has been an increasing trend amongst companies to publish a variety of information relating to themes such as community, corporate social responsibility, environment, health and safety. Indian companies, therefore, present diversity in content and format under the overall umbrella of sustainability reporting. Traditionally, while many organizations both in the public and private sector practice some sort of corporate social responsibility programmes, reporting has not been a common practice. A survey conducted in 2003 by "Partners In Change" showed that 70 per cent of the participating companies do not have a CSR policy, but are nevertheless doing "good work". However, over the past few years, there has been an increasing awareness and activity in the CSR field and many companies have started some reporting on sustainability issues, albeit in limited and diverse formats.

19. Many organizations in India have certified environmental management systems, based on ISO 14001. Consequently, data on environmental indicators are more readily available and many companies have started reporting by issuing environmental reports which also include health and safety data. It is only after this initial phase that companies in general start developing reporting formats that conform with the GRI Guidelines. In accordance with global trends, some Indian companies have also started seeking independent assurance on their sustainability reports.

Reporting under environmental legislation

20. One of the fundamental features of India's ancient philosophy has always been respect for the environment. The Indian Constitution is amongst the few in the world that contains specific provisions on environmental protection. State policy principles explicitly enunciate the national commitment to protect and improve the environment. The national environmental policy framework is the responsibility of the Ministry of Environment and Forests. Implementation is undertaken by the Central Pollution Control Board (CPCB) and the State Pollution Control Board (SPCB) at the Central and state levels respectively. The Department of Environment at the Central level supports the SPCBs. The Environment (Protection) Act of 1986, considered as the "Umbrella Act", was formulated for the protection and improvement of the quality of the environment and prevention, control and abatement of environmental pollution. The Act is also an "enabling" law, which articulates the essential legislative policy on environmental protection and delegates wide powers to competent authorities to frame necessary rules and regulations.

- In terms of this Act, each covered organization should submit an annual "environmental audit report" (in a prescribed format) to the relevant SPCB.
- Reporting in the environmental statement includes parameters such as water and raw material consumption, pollution generated (along with variations from prescribed standards), quantities and characteristics of hazardous and solid wastes, impact of pollution control measures on conservation of natural resources and on cost of production, and additional investment proposals for environmental protection. At this stage, the statement is not required to be audited. The legal requirement on its preparation and submission helps ensure that data on environmental measures is collated, categorized and analysed by all businesses covered under the legislation. Many organizations in India have started to audit these statements internally with a view to improving their environmental performance and as a matter of good practice.

Reporting under the Companies Act

21. The Companies Act in India governs the overall regulation of companies in India and includes sections on disclosure and reporting on various aspects of company operations. Section 217 of the Act stipulates that the Board of Directors' Report (attached to every balance-sheet tabled at a company annual general meeting) shall contain information on conservation of energy. The latter is expected to include:

- Energy conservation measures taken;
- Additional investments and proposals, if any, being implemented for reduction of the consumption of energy;
- Impact of the measures taken above for reduction of energy consumption and consequent impact on the cost of production of goods; and
- Total energy consumption and energy consumption per unit of production in respect of specified industries.

Reporting on social matters

22. Traditionally, there has been a very thin line of demarcation between socially aware entrepreneurship and philanthropy. Businesses today are becoming more aware of the business case that social responsibility is not limited to acts of charity and that it requires internalization and systemic expression. In 1980, Tata Steel released a "Report of the Social Audit Committee" which explored whether the company had fulfilled the objective contained in the Articles of Association regarding its social and moral responsibilities to consumers, employees, shareholders, the local community and society. Since then, there has been a growth and consistent improvements in the quality of reporting of Indian companies. Discussions reveal that sustainability reporting in India often starts as a voluntary initiative amidst limited pressure from local NGOs/civic society to publish sustainability reports. Reports are often produced and used for internal purposes.

23. The GRI has been working with the Confederation of Indian Industry (CII) for a better understanding of the Indian context of reporting and ways of applying the international framework standard domestically.

The main challenges for sustainability reporting in India are the following:

- Lack of a specific sustainability/CSR reporting legislation or guidelines;
- Companies find it challenging to report how they conduct business in the absence of clear guidance based on local conditions;

- Following early experimentation, efforts need to be focused and reporting standardized. Typically, companies tend to report their community initiatives on a few pages in their Annual Reports rather than providing detailed information on internal practices and issues such as transparency, risk, and social or environmental impacts; and
- Synergizing social and business interests needs top priority. Corporate philanthropy needs to transform into the realm of core business and corporate social responsibility.

Initiatives of RBI

24. Recognising the contribution of financial institutions including banks to sustainable development considering the crucial role they play in financing the economic and developmental activities, the RBI had drawn the attention of banks to their role in Corporate Social Responsibility, Sustainable Development and Non-Financial Reporting in its circular dated December 20, 2007. Since the loan management in banks is in their operational domain, banks were exhorted to keep abreast of the developments in this regard and dovetail / modify their business strategies in the light of developments. Apart from this, even internal efforts to make their day-to-day operations cleaner, greener and more efficient can help. However, as remarked earlier, the position continues to be in early stages of development and lot of work is needed in this direction.

25. One of the key initiatives of RBI and where we are different from any other regulator is in the area of sustainability reporting and financial inclusion. Sustainability has been an integral part of our inclusive growth agenda. We have tried to convey to banks that they must have an objective of financial inclusion. All the banks have been advised to prepare a board approved financial inclusion plan. As we are following a bank-led inclusive growth agenda, they must demonstrate their commitment to do so. That will give sustainability a greater depth and penetration. Now, whether we make NFR mandatory – make it a part of disclosure – has been engaging our attention. But, in so far as directing banks that sustainable growth can be an important agenda for banks, guidelines have been issued.

Sustainability reporting-way forward for banks and financial institutions

26. The progress of sustainability reporting in India is slow, but a significant and sound start has been made. The Institute of Chartered Accountants of India – Accounting Research Foundation (ICAI ARF) Committee is working on a new set of rules on CSR and, CII is developing a green rating system for Indian companies. The pressure to adopt sustainability has further intensified with the launch of Sustainable Development Funds and Indices in India such as CRISIL, S&P ESG Index.

Role of society

27. The role that the society plays in nudging financial institutions to adopt NFR can be catalytic. As a society, while judging a financial institutions' performance, we must appreciate their contribution to social responsibility. As an illustration, when Best Banks' Awards are given, only financial parameters like CRAR, ROA, RoE, NPA, etc. are considered. But are the banks judged on parameters like responsible ethical lending? How they meet their social responsibility? How they are faring in serving below poverty line people? How many customers served? What is the intermediation cost? What is the treatment meted to small customers? Are the charges levied for such small customers exorbitant in nature? Do they have a policy of reducing carbon foot print? When these aspects are not taken into consideration, and if the society does not appreciate these while rewarding the banks, how do you expect that these will be reflected in corporate performance? Were such factors taken

into account, then the recipients of Best Banks Awards would, probably, be very different from the actual recipients of today.

28. Banks and Financial institutions would benefit by developing a sustainability management and reporting framework, which covers, but is not limited to, identification of material issues and risks, conducting stakeholder engagements as well as environment, health safety and social (EHSS) audits, mapping the carbon footprint of a company's operations and developing sustainability reports.

Conclusion

29. To conclude, I once again congratulate NextGen and GRI for having organised this Conference which provides an important platform for creating awareness and sensitising financial institutions about non-financial reporting. It is a concept whose time has come but it has to transform into a movement. RBI has been encouraging banks to adopt greater environmental and social disclosures apart from financial. But not much has happened on this front, although, on the inclusive agenda front, there has been progress but it has not yet formed part of non-financial disclosures. In order to make an impact, banks need to integrate the concepts of inclusive growth and their risk management processes for assessing performance, CSR and NFR with their business strategy. As society starts rewarding and judging performance of financial institutions by their social, environmental performance and inclusive growth agenda, apart from economic, financial institutions would be more motivated to voluntarily adopt NFR. I wish the deliberations all the success. I hope that some of the issues that I have raised are discussed in this Conference and if any action point emerges which we can address in furthering our sustainable and inclusive growth agenda, we would look forward to receiving it.