Can reporting PREDICT A CRISIS?

Companies are strengthening their non-financial disclosure in line with stakeholder expectations. But has this moved us any closer to predicting – and, more importantly, averting – corporate crises? Producing strong reports is an important step in this direction, although understanding how to interpret and use the information they contain is equally critical. There seems to be a consensus that we are not yet there.

With the advent of King III and integrated reporting, South African companies are under increasing pressure to publicly communicate their approach to managing environmental, social and governance (ESG) issues. Advocates of integrated reporting emphasise the management benefits this approach delivers, arguing that the process of producing integrated reports should help companies to identify and manage their most material issues, capture opportunity and mitigate risks.

Integrated reporting is also meant to benefit the end user. For example, investors are encouraged to use these disclosures as a source of critical non-financial information that can highlight investment upside as well as downside risk.

In general, listed companies in South Africa are embracing integrated reporting and have already delivered a number of integrated reports. However, the quality and robustness of disclosure vary widely.

Reporting frameworks, standards and guidelines are emerging in South Africa and internationally (see box). These aim to promote quality reporting and are, indeed, making disclosure more robust. But even as the volume of non-financial reporting increases, are companies better equipped to identify impending disasters? In other words: is reporting alone enough to predict a crisis?

Looking beyond reporting aesthetics

There is a common misunderstanding that companies which produce the best integrated or sustainability reports are the most sustainable companies. While there may be a link, it is important to understand that transparency and performance are two very different things.

African Bank, for example, produced what was widely regarded as an excellent report in 2013, less than a year before its highly publicised meltdown. The company adopted a risky business model heavily based on unsecured lending. It openly acknowledged this while outlining a cogent strategy based on this risk. No one can accuse the company of taking the issue lightly. Indeed, it produced a candid report full of disclosure and discussion on the very issues that ultimately led to its fall. It appears that many investors agreed with African Bank's assessment of its own outlook. Nonetheless, billions were lost when the company

KEY REPORTING FRAMEWORKS

The frameworks driving sustainability among South African corporates provide a combination of principle- and indicator-based guidance. But are they encouraging a tick-box approach, particularly among companies at the early stages of their reporting journeys?

King III provides a set of governance requirements for listed South African companies. Notable among these is the requirement that companies integrate non-financial information into their annual reports.

The Companies Act 2008 (Act 71 of 2008) requires management and senior oversight of non-financial issues through a board-level social and ethics committee.

The Global Reporting Initiative (GRI) provides a series of detailed sustainability indicators and reporting principles. It encourages reporters to focus on the aspects most material to their business, but it has been accused of encouraging a tick-box mentality.

The International Integrated Reporting Framework, produced by a broad range of global contributors, provides reporting principles and suggested content elements for integrated reports.

crashed in August 2014.

How much of this can be attributed to reporting? Essentially, a report should set out a company's strategy, provide performance data against this strategy, and demonstrate that the company understands the market trends and other external factors that impact on its performance. Provided the company gets this right, it is the reader's responsibility to analyse the information, interpret the company's outlook and make decisions accordingly.

The world is a complex place, and no one who writes or reads reports can be expected to accurately predict the combination of internal and external factors that will impact on performance during a particular period. Warren Buffet may be held up as an oracle. But, just as any credible analyst should, he makes decisions based on a combination of information provided by companies and his understanding of external conditions. Doing this well takes skill. Indeed, an award-winning report in the hands of an inexperienced analyst can lead to poor decision-making.

Just as corporates are under increasing pressure to embed ESG issues into their strategy, investors are also under pressure to incorporate the same issues into their investment processes. The Code for Responsible Investment in South Africa (CRISA), the UN's Principles for Responsible Investment (UNPRI) and South Africa's Regulation 28, along with vocal asset owners such as the Government Employees Pension Fund (GEPF), are certainly raising awareness of ESG issues among asset managers. However, the skills and tools required to interpret and analyse information in reports are still in the early stages of development. As a result, investment decision makers are not necessarily equipped to evaluate non-financial risk and this may help to explain why many of them are blindsided by crises.

Hearing the unspoken truths

Interpreting a report's content can be challenging, but with a certain degree of logic and basic business knowledge, a reader can understand the key messages. Noticing omissions, however, takes greater skill. How can we know what we are not being told if no one is telling us about it? Hearing the unspoken demands industry knowledge, backed by financial and non-financial acumen.

For example, Lonmin, a long-standing name on the Johannesburg Stock Exchange (JSE)'s socially responsible investment (SRI) index, devoted significant space to its workforce in its 2011 integrated report. Topics such as transformation, housing and safety featured prominently, giving an initial impression that the company understood its workforce's concerns and was addressing them adequately.

But to the trained eye, the report was packed with warning signs. A brief disclosure of a wildcat strike gave no explanation for the strike's cause. To those familiar with the mining sector, certain incendiary topics such as living-out allowances, labour broking, pay tensions and inter-union dynamics were absent. These factors ultimately were instrumental in the company's violent and debilitating strikes during the following year.

While most of these issues are relatively unique to the mining sector, a skilled mining sector analyst should know what to look for. Indeed, spotting such warning signs can help avert significant loss of value. Lonmin's share price has yet to recover to pre-Marikana levels after falling by more than 30% in the week following the tragedy.

A tick-box approach to reporting has emerged as an unfortunate side-effect of some

> **"A tick-box approach to reporting has emerged as an unfortunate side-effect of some well-intentioned frameworks and awards. Companies that take this approach can, in fact, obscure the critical issues."**

well-intentioned frameworks and awards. Companies that take this approach can, in fact, obscure the critical issues. Those reporting faithfully to the Global Reporting Initiative (GRI)'s list of over 100 sustainability indicators can find themselves obscuring their performance against the issues most material to their business or sector. Unfortunately, the drive for complete disclosure can compromise a report's ability to focus on materiality, leaving readers to sift through volumes of less-important information. When this happens, it becomes easy to miss the red flags.

Reporting cannot flag rogue events

If compiled correctly and interpreted by a qualified reader, can we expect non-financial reporting to flag all potential crises? Unfortunately not. While slowly unfolding issues may come to light through sound reporting, it is important to remember that rogue events and unpredictable behaviour are exactly that – unpredictable.

PPC Limited's recent governance squabble provides an excellent example. Integrated reports rarely, if ever, delve into interpersonal issues. Bickering among board members and executives never features in public reporting. However, such rivalries can present significant challenges to business performance, as exemplified in the case of PPC.

It is certainly useful to know about issues of this sort. But unless you are fortunate enough to have an insider's perspective, you are unlikely to discover them through formal or public channels until it is too late. And the stakes are high: PPC's share price fell by more than 25% in the months following the public spat between its CEO and board.

Similarly, serious obstacles do not always give advance warning. At present, most integrated reporting has not yet migrated from the once-a-year print report to the type of continuous, integrated communication encouraged by the International Integrated Reporting Council. Consequently, external stakeholders are given a glimpse into the elements that the company defines as material once every 12 months. This does not provide a very up-to-date picture of a dynamic business environment.

"External stakeholders are given a glimpse into the elements that the company defines as material once every 12 months. This does not provide a very up-to-date picture of a dynamic business environment."

Meeting stakeholder expectations

If reporting is inherently imperfect and interpreting disclosure is a daunting proposition, is reporting a futile exercise? Not necessarily. However, certain expectations should be met to ensure all parties achieve their outcomes.

For example, businesses should give their stakeholders the information they need to make their own decisions. This means taking materiality seriously and reporting transparently and candidly in a balanced manner. It also means providing meaningful information on a continuous basis by integrating relevant non-financial information into interim updates, roadshows and other communications channels. The link between non-financial and financial performance should be clear to the business as well as its stakeholders.

Investors need to use this information wisely and understand the external factors that impact performance. They can't simply take the CEO's word that everything is going smoothly.

Above all, it is important to acknowledge that the world is chaotic and random, and nobody – not even Mr Buffet – is right 100% of the time. Reports are only one decision-making tool, and it is important to understand that they will inevitably carry some bias. After all, we can hardly expect a company to proclaim its own demise. However, when reporting is carried out correctly, it should help companies and their investors to identify – and manage – their greatest risks and, therefore, avoid crises.