

ALL TOGETHER NOW

Why sustainability reporting and the annual report should be combined.

By Don McGrath and Gregg LaBar

Of the more than 80,000 transnational companies, roughly 4,000 of them issue a report on their sustainability, corporate responsibility (CR), and corporate citizenship programs, according to data compiled by the Global Reporting Initiative, CERES, and other sources.

A number of reasons might explain the failure to communicate on sustainability, but it is a missed opportunity for many companies. Sustainability—the “triple bottom line” that addresses social, environmental, and economic outcomes—belongs as part of the annual report because it reflects an important measure of performance that should be captured in the most important, transparent, and far-reaching communications document a public company produces.

Eaton Corporation, a \$13.7 billion diversified power management company, has found that the most effective way to report on its sustainability efforts is in the annual report to shareholders, and the company has been doing so since the 2006 annual report. The sustainability section in Eaton’s annual report covers environmental performance, health and safety, business ethics, and citizenship, supplemented by web-based access to sustainability data, progress reports, case studies, and more. (See Eaton’s sustainability web page at <http://eaton.com/Eaton/Sustainability/index.htm>.) At the same time every year, all in the same place, Eaton reports its financial and sustainability performance and progress to all of its stakeholders.

A 2008 study by KPMG Sustainability and SustainAbility Ltd. (Count me in: The readers’ take on sustainability reporting) indicated that report readers preferred to see sustainability information fully integrated into annual reports and other corporate communications. In fact, 70 percent of those surveyed are predicting “the end of sustainability reports” by 2020, according to the study.

Reporting Is Shifting

For now, the vast majority of companies that report on sustainability/CR do so in a separate report. According to our field research, a small fraction of companies worldwide currently address CR/sustainability in their annual report without issuing a separate report. However, we believe this approach reflects a trend and the way forward for many public companies.

In our view, at least three compelling reasons argue for integrating sustainability reporting into the annual report.

1. Socially responsible investing. An increasing number of institutional investors, mutual funds, and individual shareholders are



explicitly incorporating environmental, social, and governance (ESG) criteria into their investment analysis and portfolio construction. According to the latest research from the Social Investment Forum Foundation, nearly one out of every eight dollars under professional management in the United States—12.2 percent of the \$25.2 trillion in total assets under management—is involved in socially responsible and sustainable investing (SRI). That \$3.07 trillion represents a 34 percent increase since 2005, while the broader universe of professionally managed assets increased only 3 percent during the same time period, according to the foundation’s 2010 Report on Socially Responsible Investing Trends in the United States. The continued growth of SRI and the importance of intangibles (which can account for 30 percent to 50 percent of a company’s valuation) mean that the sustainability/CR audience is the annual report audience.

2. Business strategy. Eaton has focused its business strategy on providing power management solutions to assist customers in reducing their carbon footprints and their energy costs. As organizations continue to gear their growth efforts toward alternative power and energy sources, the linkage between business strategy and social responsibility becomes increasingly important. As a result, in order to assert the company's value proposition to investors, companies should include mission-critical sustainability information in their annual reports because it is impacting companies' financial results and long-term outlooks. Furthermore, including this information in the annual report reaffirms for all audiences the importance that senior management and the board place upon these sustainability efforts.

3. Efficiency and cost effectiveness. Large companies such as Eaton invest significant time and resources in the annual report. Separate sustainability reports require a significant additional commitment of time and resources. In fact, we are aware of a number of companies that actually spend more time and money on their voluminous sustainability reports than their annual reports. (It's no wonder some companies have gone to biannual sustainability reporting.) Some companies simply do not have the resources and time to take on another large report production process. We do not believe that should prevent them from reporting on their sustainability goals and progress.

With so much investor attention now being paid to socially responsible investing and various intangibles, it may be only a matter of time until more companies integrate the two reports into one publication. For us, it is not hard to imagine that the typical annual report in the not-too-distant future will consist of a letter to shareholders and narrative section that discuss the company's strategic focus, and financial and sustainability performance and progress, followed by essential financial and sustainability statements, notes, and tables. For more information, readers would reference the 10-K and the equivalent sustainability form, which would most likely be based on the Global Reporting Initiative guidelines. A combination of print, video, online, e-book, and other forms of media could be used.

From a theoretical perspective, the "integrated reporting" movement is gaining steam, inspired by the book *One Report: Integrated Reporting for a Sustainable Strategy*, by Robert G. Eccles and Michael P. Krzus. The authors argue that "integrated reporting shapes how a company sees itself." They would like to see "one report" that reports on performance in many areas such as financial, environmental, social, governance, diversity, ethics, and community engagement—all measured against established standards and independently verified. According to Eccles, who teaches at Harvard Business School, a few very large global companies such as BASF, Novartis and Novo Nordisk, Philips, and United Technologies Corporation have made big moves in this direction.

Eaton's Process

Eaton is committed to a high level of sustainability reporting and transparency. As we began to lay the groundwork for our first sustainability report, Chairman and CEO Alexander M. Cutler accelerated the timetable by asking that sustainability reporting begin with the 2006 report. And, as the internal champion of the annual report, Cutler felt sustainability belonged in that official, widely circulated document. Nothing can replace decisive, C-suite-level leadership and strong board support.

Eaton's 2006 annual report introduced the company's sustainability reporting under the annual report theme of "The Power to Make a

Difference." The letter to shareholders explained, "This year—thanks to a new internal system that enables us to measure those efforts consistently across our organization—we are able to share our progress with you by publishing our first sustainability report....Over time, we will strive to achieve continuous improvement across these measures, while maintaining our commitment to delivering superior financial results."

In Eaton's view, sustainability is about "doing business right," which pays dividends to customers and employees, as well as rewarding investors both in the short term and the long term. Cutler has said, "We operate from a position of integrity in all that we do and care deeply about how we get our company's results." That means Eaton aims to provide a fair and honest assessment of its performance, including its activities, its progress, and its shortcomings. The commitment to transparency means, for example, that Eaton not only reports total emissions and percentage changes, but also indexes those numbers against changes in sales. Eaton does not claim to have all of the answers, and believes readers are interested in both the process Eaton is using to address sustainability and the metrics and performance against the metrics. Eaton expanded its sustainability reporting online in 2009 with quarterly reports on key performance metrics.

Eaton has received direct and consistent feedback from several of its largest, long-standing investors that they value the annual report and the way it connects strategy execution and financial and sustainability performance. The 2009 annual report summarizes the connection as follows: "We believe financial performance and social responsibility go hand in hand. During 2009, we didn't waver from that belief—or our commitment to sustainability leadership—despite the challenges posed by the weak global economy. In fact, under almost any scenario, the demand for improved power management, Eaton's core capability, will grow as escalating energy demands and carbon regulations increase the cost to power our homes, businesses and communities. Eaton is well positioned to answer that demand—not simply because we engage in sustainable practices, but because we are building a culture in which sustainability permeates everything we do as a company."

Given the breadth of Eaton's annual report, it should be no surprise that it takes a significant team effort to complete the project. The brainstorming and planning process, led by corporate communications, starts in mid-summer, and involves the IR, finance, HR, legal, government and community relations, EHS, supply chain, and business unit/regional functions. Their involvement is critical because they all have information and perspective to lend to the project. The annual report is used in so many ways—as an investor tool, for employee engagement, as a recruiting tool, for community relations, with the media, and to make our markets aware of our total capabilities and responsibilities.

The Eaton approach would be a big step for companies that have a successful track record with a separate sustainability report. At a minimum, those companies should begin to cross-reference their two reports. For many other companies—in fact, the vast majority of publicly traded companies around the world, which don't currently report on CR/sustainability—the annual report will emerge as the best way for them to report to their key constituents on this issue. It works.

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