

From Transparency to Performance

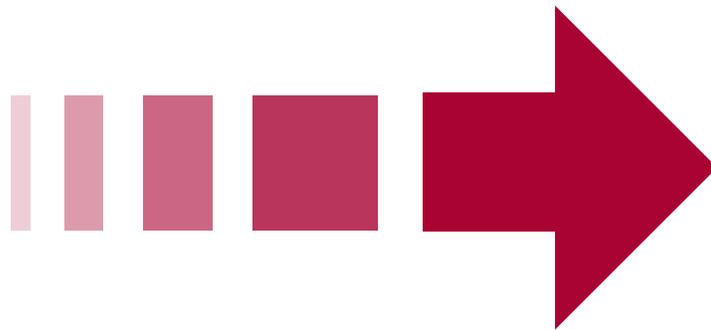
Industry-Based Sustainability
Reporting on Key Issues



THE HAUSER CENTER
FOR NONPROFIT ORGANIZATIONS
at HARVARD UNIVERSITY



INITIATIVE FOR
RESPONSIBLE
INVESTMENT



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Foreword

The need to set down our thoughts on how a system of Key Performance Indicators (KPIs) might be developed and integrated into the broader movement to mandate the disclosure of sustainability data grew from three convictions. First, we were convinced that improved disclosure of sustainability data in the US is both necessary and needed urgently. Second, we were convinced that it must be mandatory, or at least to some extent. Third, we believed that better guidance could enable companies to be in a stronger position to rise to the challenge of sustainability reporting and see benefits rather than burdens. It is our hope that establishing sustainability KPIs for all sectors will enable companies to move from a compliance driven “disclosure” mindset to one of managing—and even competing on—performance on the sustainability issues that matter most.

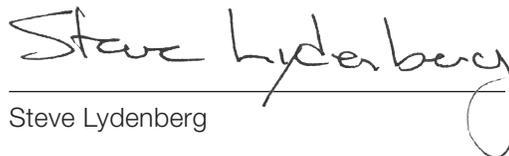
At the same time, we recognized that it is difficult to determine exactly which of the many facts and figures that make up the full range of sustainability data—crucial information about how corporations affect our daily lives and their implications for generations to come—should be disclosed. Many have tried their hand at enumerating those most important sustainability data points. The Global Reporting Initiative is chief among those tackling this task, but the French government’s New Economic Regulations of 2001 have set out its own list of 40 key indicators; Dow Jones and FTSE have come up with scoring systems and key indicators in constructing their sustainability stock indexes; and SustainAbility and AccountAbility have devised systems for determining the most material and comprehensive sustainability reports.

One thing was clear to us from these various and varied initiatives—the guidance must be relevant to the core operations of the business, and the sustainability data disclosed as a result must be relevant to key stakeholders in the corporation, including not just the stockowners, but customers, employees, communities, suppliers, and the environment. Transparency in the data these stakeholders want and need is the crucial first step on the road to better performance—i.e., changing corporations’ actual practice in daily life and making companies more responsive to global challenges and the needs of today’s society.

Deciding which data points should be disclosed and by whom is critical for the success of this next step in the managing of corporations' relations with society. This decision must successfully identify those data points that are most important to the widest array of stakeholders for issues on which change is most needed and most possible in a resource constrained society. The process for making this decision must itself be transparent and trustworthy. The result must be practical and useful.

Determining a legitimate process for implementation is the important first step in going down the road to mandatory disclosure. If the process is properly conceived, the most appropriate data points will flow from it naturally and evolve as needed to address new issues and concerns. For this reason, we have concentrated here on how a process for determining KPIs might be best developed, rather than on determining indicators themselves, although we have used hypothetical case studies to demonstrate how this process might produce specific results. This process provides new insights into how to approach understanding the materiality of sustainability issues, as a prelude to disclosure and management. As such, it is useful not only for regulatory or standards-setting bodies, but for corporations struggling to put processes in place to manage the risks and opportunities associated with material, non-financial issues facing their sector.

We recognize that the task at hand is challenging and its implications extend well beyond the financial community. Many regulators, financial professionals, and non-governmental organizations around the world today are tackling this challenge, as countries around the world move toward imposing their specific solutions to this problem. What exactly will be the outcome of this movement toward mandatory sustainability disclosure in the US and beyond may not be entirely clear today, but we hope that the ideas brought forward in this paper can contribute to that important debate.



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June 2010
Cambridge, Massachusetts

Executive Summary

This paper proposes a method for identifying key performance indicators on the sustainability—or social and environmental—impacts of US corporations in specific industries. We believe that mandatory reporting by US corporations on their impacts on society and the environment is not only desirable, but inevitable. What specific data needs to be reported and in what form, however, remain challenging questions. We believe that it is crucial to pursue simultaneously both mandatory reporting of sustainability indicators in a standardized format and reporting on key performance indicators specific to particular industries. Thorough work has been done by the Global Reporting Initiative (GRI) on establishing a credible set of universally applicable indicators. More work needs to be done on how to determine relevant sector-specific key performance indicators as a minimum basis for sustainability reporting.

Over 3,000 corporations around the world now engage in sustainability reporting. Historically, sustainability reporting by US corporations lags behind that of their peers in other regions of the world¹. As an increasing number of governments and stock exchanges encourage or require sustainability reporting, corporations and financial markets in the United States run the risk of diminishing their competitiveness in sustainability. This data can be crucial in aligning business practices with those of a sustainable economy and in providing a means for benchmarking the performance of large corporations as they interact with society and the environment.

Our method for developing key performance indicators (KPIs) for sustainability relies on three principles—simplicity, materiality, and transparency. Building on a broad disclosure framework such as that of the Global Reporting Initiative, this method suggests how those sustainability KPIs most material to all stakeholders can be identified.

We believe that this proposed method for establishing KPIs can be useful for, among others:

- Regulators or stock exchanges contemplating increased targeted requirements for sustainability reporting;
- Corporations seeking to enhance the credibility of their sustainability reporting and improve its integration into financial reporting on material factors;
- Stakeholders seeking to better understand the most important elements of a corporation's sustainability performance;
- Investors seeking to improve the sustainability analysis they incorporate into their assessments of company value.

Our goal is to encourage the uptake of sustainability reporting in the United States. This can be achieved in part through the development of concise guidance on key material sustainability issues for specific industry sectors. Focusing on key sustainability issues for each sector can facilitate the emergence of a reporting framework in which sustainability and financial reporting converge.

Our goal is to encourage the uptake of sustainability reporting in the United States. This can be achieved in part through the development of concise guidance on key material sustainability issues for each sector that should be disclosed by all companies at a minimum.

1

Mandatory Sustainability Reporting

Introduction

As voluntary sustainability reporting has become an increasingly common practice among large corporations, the question arises as to whether or not such reporting should remain strictly voluntary.

Over the past three decades, advocates from various stakeholder groups—investors, employees, communities, environmentalists, consumers, and regulators alike—have sought to expand corporate reporting to include environmental, social and governance (ESG) data. Substantial progress has been made by such organizations as the Global Reporting Initiative (GRI) both in defining what constitutes enhanced corporate reporting in these areas and in convincing corporations to produce voluntary reports addressing sustainability and ESG issues (further information about GRI can be found in Appendix A)².

These reports go by a variety of names, including sustainability, ESG, corporate social responsibility, triple-bottom-line, corporate citizenship, and environmental, health and safety reporting. In this paper, we will refer to these generally as “sustainability” or “ESG” reports³.

As voluntary sustainability reporting has become an increasingly common practice among large corporations, the question arises as to whether or not such reporting should remain strictly voluntary, or should be mandated by regulators or stock exchanges. A number of governments have already made broad-based sustainability reporting essentially mandatory—France and Sweden, for example (see Appendix B).

According to the World Federation of Exchanges⁴ there were almost 50 socially responsible investing (SRI) indices offered directly or indirectly by stock exchanges; these indices are predicated on, and therefore encourage, the disclosure of a broad range of social and environmental indicators—the JSE in South Africa and Bovespa in Brazil, for example.

Although the United States is still far from a system of mandatory sustainability reporting, in early 2010, the US Securities and Exchange Commission (SEC) issued guidance to US corporations on their obligation to report on climate-change-related data when it might be deemed material to an assessment of the firm's future prospects. This guidance reminds corporations that they already have an obligation to report on social and environmental factors that might materially affect the firms' performance⁵.

The SEC guidance was based on existing legal requirements to report on emerging trends, events and uncertainties. The guidance was warranted because NGO and investor surveys of SEC filings show that, in the absence of SEC guidance, environmental and social issues disclosure in SEC filings is sparse, inconsistent, and typically omits large issues facing the company⁶.

This paper argues that sustainability reporting must to some extent be made mandatory in order to assure that comparable sustainability data is available to investors and other stakeholders who might wish to form judgments of the materiality of this data on their own. It also argues that tailored key sustainability performance indicators, which vary in their materiality from industry to industry, should play an important role in such disclosure.

We wish to stress at the outset that this paper does not provide a definitive list of KPIs for industries. Rather it suggests a method by which such KPI indicators can be established in a transparent and flexible manner. By demonstrating the feasibility and benefits of such an approach, we hope to encourage the consideration of the important role that KPIs should play in mandatory reporting schemes in the US. For illustrative purposes we have conducted an experimental test of the method we are proposing, in order to help readers understand its promise.

The examples of KPIs that we have derived should not be taken as more than suggestive at this point. Our focus is on outlining a process that could be implemented in the US to address the materiality of sustainability issues and determine KPIs for all sectors in a cost- and time- effective manner.

A determination of which body is most appropriate for ultimately establishing the KPIs themselves falls outside the scope of this report.

The Growth of Voluntary Sustainability Reporting

According to the CorporateRegister.com, the number of sustainability and similar reports issued yearly by corporations has grown from 26 in 1992 to over 3,000 in 2008⁷. The world's largest companies now issue sustainability reports as a matter of course. In the United Kingdom, for example, some 86 percent of the FSTE 100 corporations issued sustainability reports in 2007. The 10 largest South African corporations all included a sustainability report in their 2007 annual reports to stockowners.

The major players in industries with direct impacts on the environment, such as the chemical, electric utility, oil and gas and mining industries, have aggressively taken up sustainability reporting. According to the CorporateRegister.com, in the first nine months of 2008 alone, some 80 major chemical companies worldwide issued sustainability reports, while 80 reports were issued by mining companies, 200 by oil and gas companies, and the electricity sector accounted for roughly another 230 reports.

Companies reporting on a voluntary basis may choose different time periods in which to report; as well as reporting on different indicators in different formats.

Similarly, a KPMG study published in October 2008 found that almost 80 percent of the Global Fortune 250 companies report publicly on social and environmental data⁸. This is a marked increase from a 2005 KPMG report which found only 50 percent of these companies publishing sustainability information.

This strong growth in voluntary sustainability reporting suggests that both corporations and their stakeholders find value in the publication of this data. However, we believe that without mandatory reporting, the crucial task of transforming sustainability reporting into actual improvements in sustainability performance will remain an especially difficult task.

The Need for Mandatory Sustainability Reporting

RATIONALE FOR A MANDATORY REGIME

Voluntary sustainability reporting, while increasingly recognized for its valuable contributions, presents a number of challenges. For example, companies reporting on a voluntary basis may:

- Choose different time periods in which to report—some may report annually, some biannually, some at irregular intervals, and some only once and then not at all;
- Report on different indicators—companies in the same industry may choose to report on the a variety of different key indicators;
- Report in different formats and using different metrics—even when reporting on the same indicators, companies may report data covering different time periods, using different units of measurements, or choosing different benchmarks against which to measure performance.

Mandatory reporting has the potential to address these challenges, and can bring with it a number of additional benefits. A mandatory regime will, for instance:

- Create a level playing field for corporations disclosing crucial information related to sustainability performance;
- Allow investors and others to make apples-to-apples comparisons of the relative sustainability performance of companies within a specific sector;
- Enable the full range of stakeholders to hold robust debates on the effects of corporate activity;
- Help internalize costs from corporate activity that the current disclosure regimes allow to be externalized onto society.

We argue here that mandatory reporting must capture a broad set of potential sustainability indicators which can be used to describe companies' impacts. The Global Reporting Initiative has, over the past decade, made substantial progress in assembling such a list of indicators relevant to a wide spectrum of stakeholders and applicable to corporations across all sectors. The GRI model therefore appears to provide a useful framework for broad-based mandatory reporting. For example, the mandatory sustainability scheme recently adopted by Sweden for companies with state ownership and strongly encouraged for other corporations in that country, relies on the GRI's comprehensive set of indicators.

We also argue that mandated reporting of key performance indicators is crucial for an effective disclosure framework. These KPIs may or may not be already captured by in a set of broad-based indicators. However, highlighting key performance indicators for each industry and sector will direct the reporting efforts of corporations and the assessment efforts of those using corporations' sustainability reports to those issues and data points most material to the broadest set of stakeholders.

Implementing a mandatory reporting regime, without specifying a minimum set of KPIs to be reported, results in increased disclosure – but not the ability to compare, track, and improve performance on the things that really matter. Reporting will be more prevalent, but the outcomes will not necessarily be better for the additional effort expended.

Properly designed, mandated transparency, whether broad based or focused on KPIs, allows public officials to set appropriate rules and regulations to moderate the social and environmental impacts of corporations. It enables NGOs to engage corporations on their effects on communities and the environment. It provides individuals and communities – whether as consumers, employees, neighbors or concerned citizens—with the information they need to inform important decisions.

In addition, mandated sustainability disclosure permits stakeholders to send clear market signals to corporations on their sustainability performance.

It will encourage companies to compete on how they mitigate their sustainability risks and how they capitalize on their sustainability opportunities. In short, mandatory reporting regimes create better disclosure, which, when incorporating key sustainability performance indicators, can lead to better performance in those areas most crucial to stockowners, other stakeholders, and society.

ALTERNATIVES TO A MANDATORY REGIME

The arguments most often made against mandatory reporting, and in favor of continuing the current regime of voluntary reporting, are typically ones of practicality and costs—it is difficult for regulators or stock exchanges to determine what data should be required and how to monitor the adequacy of its reporting; and it is expensive for companies to compile sustainability data.

As a half-way step toward mandatory reporting, a number of governments have mandated that companies engage in corporate social responsibility reporting without defining which sustainability indicators are to be reported or in what format. Under some such systems companies can choose not to report at all as long as they explain why they have chosen not to do so. As of 2009, Denmark, for example, had adopted a mandated disclosure system of this type, as had Malaysia.

Another approach that encourages sustainability reporting, but that falls short of actual mandates for specific indicators, has been taken up by several stock exchanges around the world—that is, the creation of socially responsible investment (SRI) indexes. The JSE (Johannesburg Stock Exchange) pioneered this approach with the launch of its SRI Index in 2001. Others that have followed in its footsteps include the Brazilian Bovespa (Corporate Sustainability Index) and the OMX (GES Sustainability Nordic Index). As of 2009, 15 of the 51 stock exchanges in the World Federation of Exchanges had launched sustainability or environmental indexes of one sort or another⁹. Sustainability indexes encourage publicly traded companies to monitor and report on their initiatives, but typically do not specify key sustainability performance indicators.

Although these steps toward mandatory reporting are encouraging, they are not sufficient to the task of assuring that comparable data on the most material sustainability issues for particular industries is available. According to EIRIS¹⁰, good quality ESG disclosure is crucial for holistic investment decision-making, but it is currently lacking across the market. Half steps toward mandatory reporting are still too unreliable to fully align the conduct of business with the creation of sustainable economies generally or to most effectively improve the actual sustainability performance of corporations.

Mandatory reporting allows third parties to:

- Fairly judge companies' sustainability policies and practices;
- Compare them to those of their peers and assess their progress or lack of progress over time in achieving sustainability goals;
- Understand how corporations in practice are or are not supporting governments' efforts to create just and sustainable societies.

Without mandatory reporting, the kind of benchmarking necessary to drive improved performance on key sustainability issues in each sector will not be possible¹¹.

Mandatory reporting regimes create better disclosure, which, when incorporating key sustainability performance indicators, can lead to better performance in those areas most crucial to stockowners, other stakeholders, and society.

These issues include many of the major challenges facing societies around the world today. For instance, advocates point out that ESG information can help society address crucial challenges of our time such as:

- Climate change and the efficient use of energy;
- Releases of toxic chemicals into the environment;
- Sustainable management of forests, fisheries, and other natural resources;
- Safety and decent conditions in the workplace;
- Equal access to technologies and financial services for all members of society;
- Availability of water;
- Equal opportunities in employment;
- The need for sustainable products and services.

The move toward mandatory sustainability reporting regimes is an important step toward capital markets that create long-term wealth and sustainability for shareholders and society alike.

US CONTEXT

Mandatory reporting is particularly important in the United States, which is host to one of the largest and most diverse set of publicly traded corporations in the world. As of year-end 2009, there were over 5,000 US companies listed on the New York and NASDAQ stock exchanges with a combined domestic market capitalization of over \$15 trillion, and many more public firms that are traded over the counter¹².

The number of companies reporting and the quality of the reporting by these companies leaves much to be desired, although these are signs of recent progress. As of 2009, only 130 US companies had registered their sustainability reports with the Global Reporting Initiative¹³. And those US corporations who do report appear not to be doing as good a job as their peers in other countries.

The U.K. consultancy group SustainAbility conducts a biannual survey of the state of CSR reporting in conjunction with the United Nations Environmental Program.

“Tomorrow’s Value” most recently published in 2006 listed the 50 companies scoring highest for quality in their CSR reporting. Only five of the top 50 CSR reports were from the United States—Nike (No.10), Hewlett-Packard (15), Ford and General Electric (tied at 25) and Gap (34)¹⁴.

Authors of a 2010 report from PricewaterhouseCoopers and Craib Design and Communications looked at CSR reports issued in 2009 by more than 1,000 companies worldwide. The report found that because companies take varying approaches to CSR reporting, it can be challenging to assess companies' actual performance, or to gauge their efforts in comparison to one another.

The report found that less than 30 percent of S&P 500 companies issued CSR reports in the US, compared to 75 percent of S&P Europe 350 firms. US businesses also trailed European ones in publishing greenhouse gas emission targets, in explaining supply-chain engagement and in obtaining third-party assurance of reports.

As recently as 2009, Microsoft, Cisco and Oracle were removed from the NASDAQ Global Sustainability Index (QCRD) due to a failure to disclose 2 out of 5 quantitative environmental metrics that adhere to GRI¹⁵.

Companies often cite a number of reasons for not devoting resources to sustainability reporting. These include the fact that ESG reporting involves an expense and time commitment they are reluctant to bear, that compiling and publishing sustainability reports distracts management from what it considers its "core" business, and that management is unclear as to the relevance of such reporting to their stakeholders.

Given the size and scope of the universe of US publicly traded corporations, we believe that only a mandatory sustainable reporting regime can assure that an adequate volume of high-quality data is available to stockowners and other stakeholders. We therefore support the July 2009 call by the US Social Investment Forum (SIF) for the Securities and Exchange Commission to require corporate issuers to report annually on a comprehensive, uniform set of sustainability indicators comprised of both universally applicable and industry-specific components¹⁶. We also support SIF's request that the SEC issue interpretive guidance to clarify what discussions companies are required to include regarding short- and long-term sustainability risks in the Management Discussion and Analysis (MD&A) section of their Form 10-K filings (See Appendix D for the type of guidance that SEC might issue for each sector regarding performance indicators and management disclosures, and Appendix E for an example of a corporate ESG disclosure response to that guidance in a Form 10-K format).

In short, we believe that the move toward mandatory sustainability reporting regimes is an important step toward capital markets that create long-term wealth and sustainability for shareholders and society alike. This can be facilitated by issuing clear, sector based guidance to which companies can respond in their Form 10-Ks or elsewhere.

Usefulness of Key Performance Indicators

To maximize the usefulness of mandatory reporting, it is essential the reporting regime integrate a means of identifying key sustainability performance indicators on a sector by sector basis. These indicators focus on the sustainability data that is most material to most stakeholders and enable corporate management, investors, and other stakeholders to encourage improvements in the most important aspects of a company's sustainability performance.

Reporting on sustainability and ESG performance is a crucial step toward a market that rewards the creation of long-term wealth in a just and sustainable society. Sustainability key performance indicators (KPIs) can play a crucial role in supporting markets that create such long-term wealth. They can form the backbone of sustainability disclosure that tracks, and allows for improvement on, those issues most tied to a corporation's environmental and social impact and most material to a company's financial performance.

A reporting regime without KPIs poses major challenges:

- Companies can expend substantial time and expense gathering data irrelevant to their primary societal and environmental impacts;
- Sustainability reports containing excessive amounts of extraneous information can make analysis and decision-making difficult for investors, regulators, NGOs, consumers, and others;
- Companies can be at the mercy of ever-increasing requests for information from an ever-increasing number of interested parties;
- Companies with prominent brands may be subject to disproportionate pressures to increase their reporting.

One of the chief challenges of sustainability reporting is striking a balance between comprehensiveness and relevance. KPIs can help in achieving the appropriate balance.

Sustainability disclosure tracks, and allows for improvement on, those issues most tied to a corporation's environmental and social impact and most material to a company's financial performance.

GRI Sector Supplements

Recognizing the need for CSR disclosure tailored to the specifics of certain industries, the Global Reporting Initiative has developed a series of Sector Supplements²¹ to its general reporting guidelines.

As of early 2010, the GRI had initiated work on sector supplements for 15 industries such as airports, apparel and footwear and food processing, and completed work on supplements for the electric utilities, financial services, and mining and metals industry.

The GRI initiates work on a sector supplement when a quorum of companies in a sector approach GRI with interests and the ability to fund the development of the guidelines.

These sector supplements provide additional guidance to companies on which GRI indicators are regarded as most relevant to stakeholders. They also highlight sections of the GRI general guidelines that require particular attention, as well as identify occasional new issues.

As with the GRI's general guidelines, these sector supplements have been developed through an elaborate stakeholder consultative process typically involving industry, NGOs, government and labor.

Comprehensive lists of potentially relevant data have been developed by the Global Reporting Initiative and other organizations. The GRI's G3 Guidelines for sustainability reporting identify and disseminate a broad list of sustainability indicators—some 80 in number— across environmental, social, and economic dimensions. In addition, the GRI is developing detailed, specific reporting guidance for industry sectors that highlight numerous indicators most relevant to that sector.

To address the issue of the relevance of specific indicators, the GRI and organizations such as AccountAbility¹⁷ have also developed guidelines that companies can follow on materiality, which help identify issues of greatest importance. These guidelines, however, are general and it is up to individual companies to determine those issues they deem most material.

A more limited and targeted approach is taken by responsible investors such as the Swiss money management firm, Pictet & Cie. Pictet takes the position that focusing on a limited number of key indicators—potentially as few as one or two per industry—is the most productive approach to sustainability research. In its March 2005 paper “Less Can Be More: A New Approach to SRI Research,” Pictet argues that it “is often easier to answer a lot of irrelevant questions than to find the answers to the few really relevant ones” and calls for the identification of a limited number of “key impact factors.”¹⁸

More recently, calls for KPIs have been coming from other European financial professionals: the European Federation of Financial Analyst Societies (EFFAS) published a guideline for the Integration of ESG into Financial Analysis and corporate valuation, which recommends incorporation of KPIs into the MD&A disclosure, in order to achieve comparability and benchmarkability¹⁹.

The German Federal Environment of Ministry has also released its SD-KPI Standard 2010-2014 which presents minimum reporting standards for relevant sustainability information in annual reports and management commentaries²⁰. These industry-specific KPIs were compiled by the Ministry from questionnaires completed by SRI investment analysts on particular ESG topics.

In our view, a KPI approach that focuses in on a limited number of the most relevant sustainability issues for specific industries has many virtues. Among other things, it can help:

- Identify those sustainability aspects of sector-specific performance that impact society either negatively or positively;
- Define the most relevant information that can be reasonably collected and reported;
- Present in a usable, standardized format data that allows comparison of relative corporate sustainability performance.

In other words, a limited number of KPIs can help contribute to a balanced reporting regime that serves the dual demands of comprehensiveness and practicability. Such a regime can build on the extensive work defining and measuring corporate sustainability already in existence, and can also guide corporations and stakeholders as they focus on issues with the greatest sustainability implications at any given time. (Appendix C provides a brief review of different sustainability reporting frameworks in use today.)

Key performance indicators work best when focused on a specific industry because the importance of specific ESG information categories varies substantially across sectors: the electronics industry faces specific challenges in supply chain management, use of toxic chemicals in manufacturing and waste disposal; retail groceries in managing their employee relations and the sustainability of the products they sell; the mining industry in human rights practices, tailings management, availability of water, government relations; and so on. As noted below, standard industry classifications suggest that there are over 100 industry subsectors for which meaningfully different sets of KPIs can be identified.

Identifying key performance indicators by sector captures the specific ESG issues most relevant to a given corporation, while at the same time enabling comparability among peer groups. It creates a tailored, usable and standardized framework for stakeholders that is flexible enough to accommodate different sorts of corporate activity. Furthermore, developing KPI's for specific industries headquartered in a particular country, such as the US, enables those KPIs to take advantage of existing data collection systems and commonly used industry terminology and to reflect national standards and policy.

RELATION BETWEEN KPI AND BROADER DISCLOSURE FRAMEWORKS

A KPI approach complements and enhances broader sustainability disclosure regimes in a number of ways. First, it dovetails with broad-based disclosure in the sense that many KPIs recur across industries. Identification of these recurring KPIs highlights those universally applicable indicators that are of greatest significance throughout the corporate world. At the same time, KPIs can enhance broad-based disclosure by identifying those KPIs that are material to only a few, or even just one or two, industry sectors. These unique sector-specific issues are often the most material, because they stem from the core activities and business models of the companies in that sector. This highlights ways in which KPI reporting can fill important gaps in broader approaches. Moreover, a KPI approach permits issues to be highlighted and addressed in detail that may be of substantial relevance to stakeholders other than the stockowners traditionally served by the financial materiality principle in reporting.

Ultimately, we believe that decisions on how to coordinate and balance sustainability reporting on more universal issues with a focus on key performance indicators will vary from region to region and country to country. Such methods should be fully transparent so that these differences can be fully understood. In addition, they should be designed with sufficient flexibility to allow for change over time.

In this paper, we propose a six-step method for assessing the materiality of a broad range of sustainability issues by industry, and then, hypothetically model the application of the method to six industries: airlines, automobiles, diversified REITS, conventional electricity, forest and paper products, and retail banks. (See Appendix D for a complete list of the KPIs for each of the six industries reviewed.)

Defining a limited number of KPIs can help contribute to a balanced reporting regime that serves the dual demands of comprehensiveness and practicability.

Convergence with Financial Reporting and Establishing Key Performance Indicators

This paper proposes a method for identifying KPIs, but it leaves for further consideration two crucial questions. The first is how KPIs should be integrated into financial reporting. The second is which authority should be empowered to define KPIs for each industry.

We believe that there is little question that reporting on KPIs can and should be integrated into mainstream financial reporting. If KPIs are to serve a useful role in driving fundamental change in business practices, their implications for the core business operations and its finances need to be spelled out and understood. Integration with financial reporting can help address one of the chief concerns about sustainability reporting today—that is, the belief that it can be simply greenwashing that pays lip service to high profile issues without driving any change to fundamental business practices. Integrated reporting helps to inform companies' decision-making by identifying potential financial and non-financial risks and rewards within their operations and allowing investors and other stakeholders to understand how sustainability issues play out in the day-to-day decision making about the basic operations of a company.

Additional work needs to be done to better understand where and how KPIs could most usefully be integrated into financial reporting. In “One Report”, Eccles and Krzus²² set forth a compelling business case for integrated reporting, without specifying regarding what should be included in the integrated report or how this could be accomplished in a comparable format. To help readers understand how this could be achieved we have included six examples of concise sector guidance for minimum ESG disclosure in Appendix D. We have included in Appendix E one hypothetical example of how a company could achieve integrated reporting using a US corporation's Form 10-K.

More complicated is the related question of who should be granted the authority to define KPIs for each industry. Five options seem likely:

- Securities regulators, i.e., the Securities and Exchange Commission in the US
- Accounting standards setting bodies, i.e., Financial Accounting Standards Board
- A new body that could be created to set sustainability reporting standards, such as a Sustainability Accounting Standards Board
- Stock exchanges, i.e., New York Stock Exchange, NASDAQ
- Other third parties, i.e., GRI, academic institutions, trade associations, financial research firms, credit rating agencies, etc.

The problem of who should determine KPIs is further complicated by the international nature of corporate activities these days. In many industries—such as automobiles, airlines, pharmaceuticals and steel—peer-to-peer comparisons cut across national lines. If different countries establish different methodologies for determining KPIs and mandate substantially differing sets of KPIs, meaningful peer-to-peer comparisons could be difficult to achieve.

For the purposes of this paper we have concentrated primarily on demonstrating the viability of a sector-based KPI method and its benefits, and we leave the vital question of institutional control for further discussion. Appendix F puts forward possible policy scenarios for convergence of financial and sustainability reporting in the US.

We believe that establishing the principle of, and method for, mandatory reporting of KPIs is an important first step, and that the challenges involved in putting this method into practice should be resolved in the context of a comprehensive discussion of the virtues and drawbacks of the various approaches.

Successfully implementing integrated reporting requires concise guidance regarding the most material KPIs that should be included within a company's Form 10-K.

2

Role of Key Sustainability Performance Indicators

A Six-Step Method for Identifying Key Performance Indicators by Industry Sector

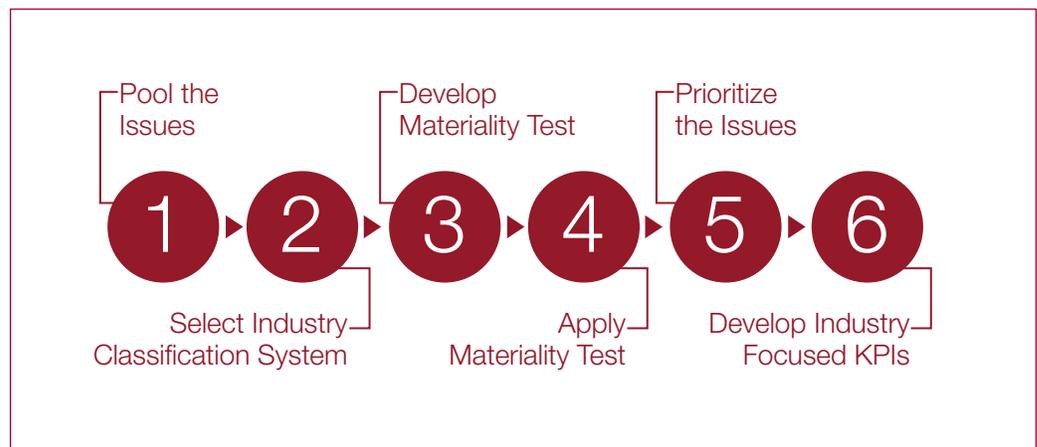
To meet the dual challenges of comparability and practicability for establishing KPIs by industry and sector, we have developed a six step method as follows (see Figure 1):

- 1 Assemble a broad universe of sustainability risks or opportunities that could apply to all industries.
- 2 Select an industry classification system.
- 3 Establish a definition of materiality to address non-financial issues.
- 4 Apply the materiality test to the sustainability issues potentially applicable to each industry sector.
- 5 Rank the materiality of these issues within each industry and establish a threshold that defines those issues that are key.
- 6 Create a tailored set of key performance indicators for the most material issues for each sector.

Below we apply this method to six industry subsectors, as defined by the Industry Classification Benchmark: airlines, automobiles, diversified REITS, conventional electricity, paper and retail banks. These six were chosen in order to represent a diversity of business practices — from manufacturing (automobiles, paper) to investment products (REITs) to services (airlines, electricity and retail banks).

Figure 1: Six-Step method for developing industry specific key performance indicators

This method was used to develop a tailored set of key performance indicators for industry subsectors, from a broad range of issues and opportunities. The method was used for 6 ICB industry subsectors with good results, and could be applied to the remaining 108 industry subsectors for a complete characterization of materiality by sector.



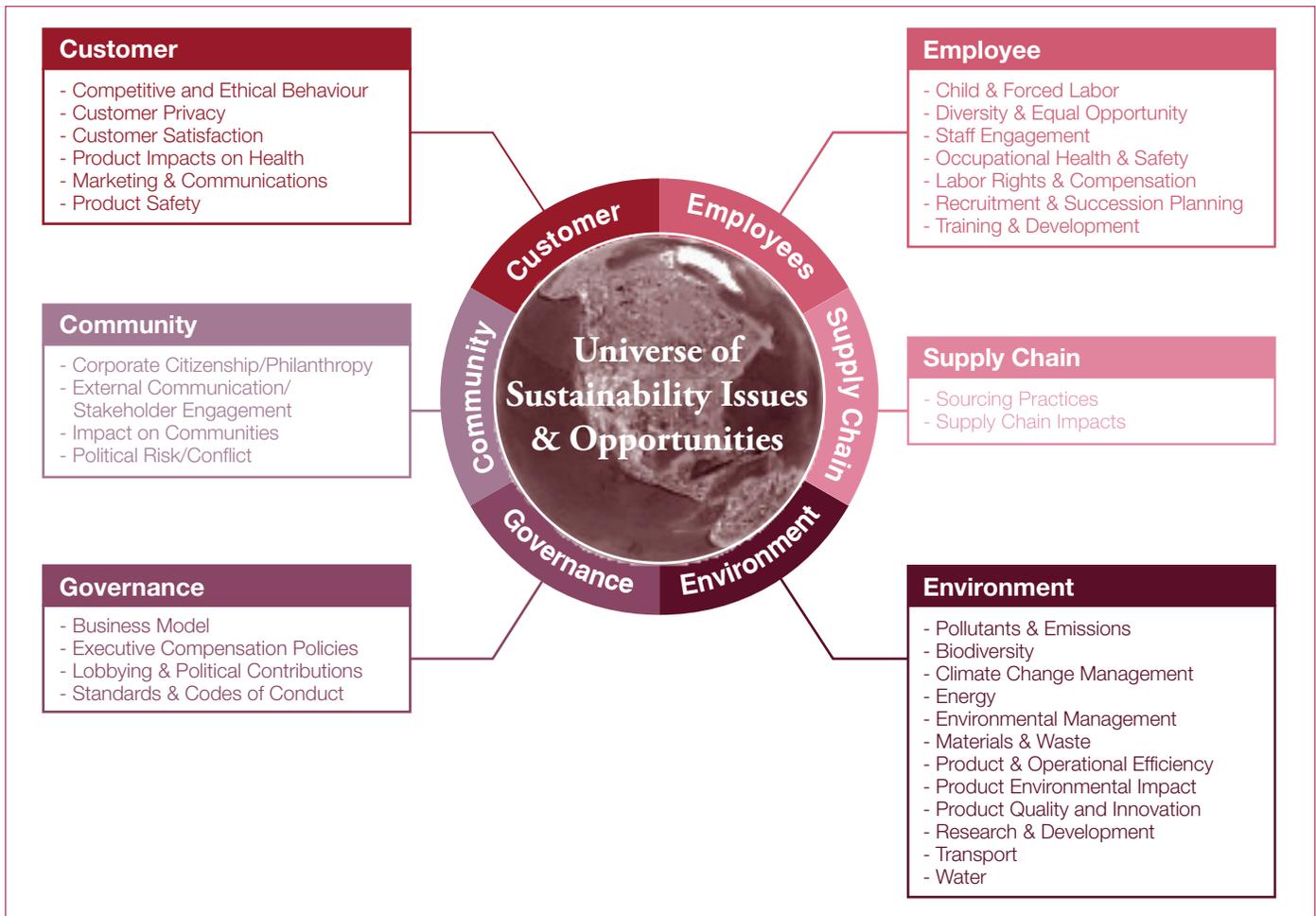


Figure 2: Universe of ESG issues and opportunities A wide range of ESG issues formed the starting point for determining what issues and opportunities are material to a specific industry subsector.

THE METHOD IN DETAIL

Step 1: Assemble a broad universe of sustainability risks or opportunities that could apply to all industries

The existing body of work on enhanced corporate reporting offers an excellent pool of issues from which to work. For this hypothetical exercise, we have drawn largely from the universe of indicators created by the Global Reporting Initiative. We have organized issues under the headings of community, customer, employees, supply chain, environment and governance (see Figure 2).

The advantages of starting with GRI's universe of sustainability issues are many, not the least of which is that they have emerged from a continuing multi-stakeholder engagement that looks beyond any single group's view of long-term impact of corporate behavior. Any reporting system will require periodic review of the universe of issues as new issues emerge and others fall away and as economies and societies evolve. As a multi-stakeholder, consultative organization, the GRI has incorporated review processes with organizational stakeholders that allow for the evolution of issues.

The 6 Subsectors Used to Test the KPI Method

(Defined according to ICB)

- **5751 Airlines:** Companies providing primarily passenger air transport.
- **3353 Automobiles:** Makers of motorcycles and passenger vehicles, including cars, sport utility vehicles (SUVs) and light trucks.
- **8674 Diversified REITs:** Real estate investment trusts or corporations (REITs) or listed property trusts (LPTs) that invest in a variety of property types without a concentration on any single type.
- **7535 Conventional electricity:** Companies generating and distributing electricity through the burning of fossil fuels such as coal, petroleum and natural gas, and through nuclear energy.
- **1737 Paper:** Producers, converters, merchants and distributors of all grades of paper. (Excludes forestry)
- **8355 Banks:** Banks providing a broad range of financial services, including retail banking, loans and money transmissions. (Excludes banks providing investment banking services).

Step 2: Select an industry classification system

To facilitate comparative assessments of KPIs, we selected a classification method to identify distinct industry groups of corporations engaged in similar activities and facing comparable ESG challenges and opportunities. We chose the sector classification system known as the Industry Classification Benchmark (ICB)²³. The system was developed jointly by Dow Jones Indexes and FTSE and is supported by the ICB Universe Database, which contains more than 60,000 companies and 65,000 securities worldwide. We utilized the classification at the ICB subsector level, which identifies 114 industry subsectors to which our method would apply (see Appendix G). Other classification systems, such as the Standard Industrial Classification (SIC) or the North American Industry Classification System (NAICS) could also be utilized. We recognize that there are limitations to any sector based approach. Not every corporation fits into a sectoral definition. Indeed, large conglomerates often participate in multiple subsectors. A KPI-based regime will have to take these complications into account and, like every classification system, will ultimately require judgment in its application.

Step 3: Establish a definition of materiality with which to test the relevance of these issues.

The next step is to extract from this universe of sustainability issues those that are most material to assessing the performance of each specific industry sector. To do this, we adapted a materiality test derived from existing sources.

The definition of materiality is of crucial importance in all discussions of disclosure. Understanding the materiality of ESG issues and how materiality changes with respect to particular industry sectors is critical for successful implementation of a minimum ESG reporting scheme. Our working definition of materiality is a modified version of the materiality test developed by AccountAbility and advocated by the Global Reporting Initiative. Our major substantive revision to the AccountAbility definition of materiality was to increase the emphasis on positive material opportunities for sustainability innovation (in business models or offerings) that might bring competitive advantage.

Our definition is broader in scope than the definitions of materiality historically used by financial regulatory parties, but by no means precludes definitions of financial materiality. Nor is it intended to replace corporate managers' responsibility to report on all financially material issues, whether or not they conform with the ESG materiality tests identified through this process. This process results in a *minimum set of material issues* subject to mandatory KPI reporting.

Our materiality test includes five categories of impact to be evaluated at a sector (or sub-sector) level (see Figure 3). They are:

- **Financial impacts/risks:** Issues that may have a financial impact or may pose a risk to the sector in the short-, medium-, or long-term (e.g., product safety)
- **Legal/regulatory/policy drivers:** Sectoral issues that are being shaped by emerging or evolving government policy and regulation (e.g., carbon emissions regulation)
- **Peer-based norms:** Sustainability issues that companies in the sector tend to report on and recognize as important drivers in their line of business (e.g., safety in the airline industry)
- **Stakeholder concerns and societal trends:** Issues that are of high importance to stakeholders, including communities, non-governmental organizations and the general public, and/or reflect social and consumer trends (e.g., consumer push against genetically modified ingredients)
- **Opportunity for innovation:** Areas where the potential exists to explore innovative solutions that benefit the environment, customers and other stakeholders, demonstrate sector leadership and create competitive advantage.

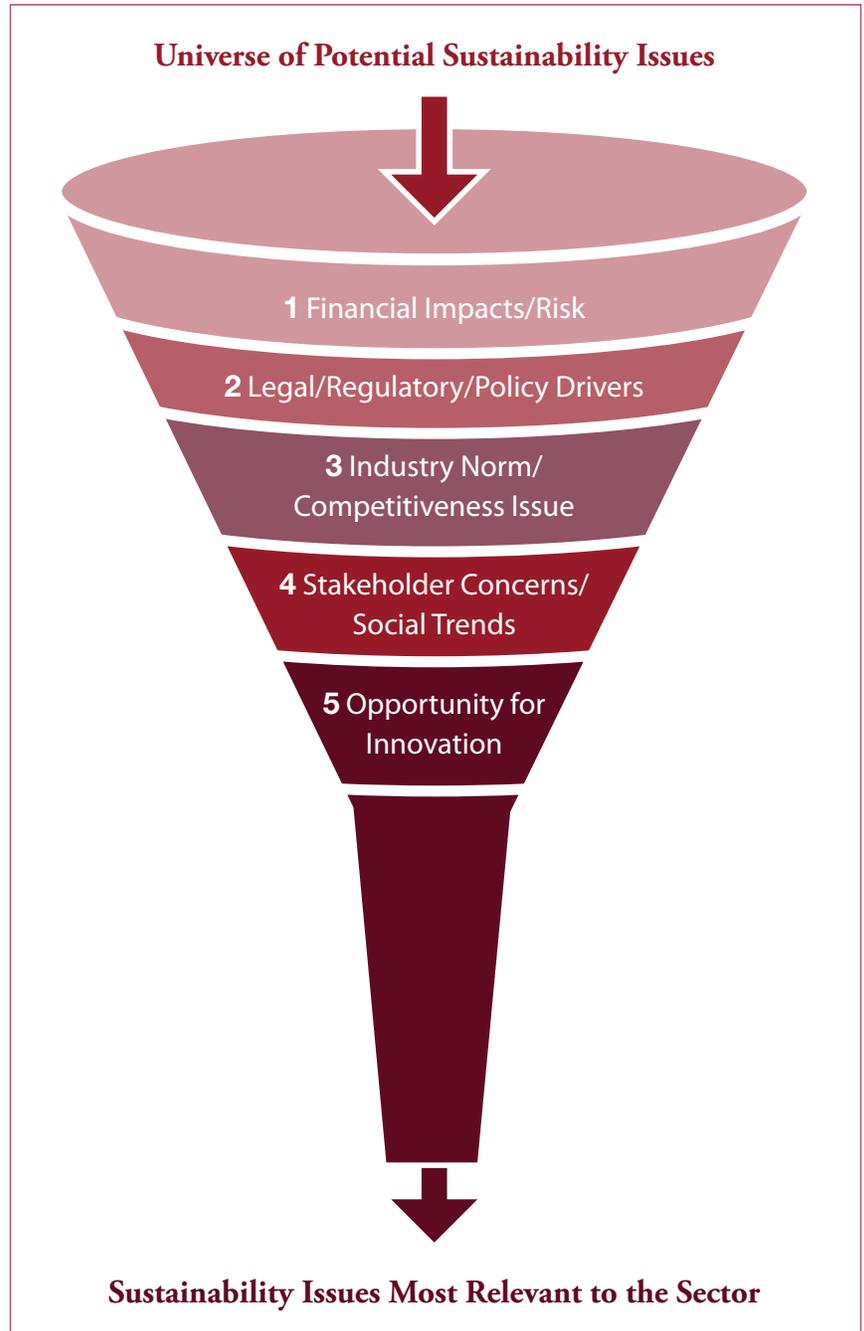


Figure 3: Materiality test Our sector-based materiality test includes, among other factors, opportunities for ESG innovation, stakeholder concerns and societal trends. Applying the 5-part test involved ranking the broad universe of issues with respect to their materiality to each sector.

Step 4: Apply the materiality test to the sustainability issues potentially applicable to each industry sector.

To identify sector-specific material issues within the broad universe of sustainability topics, we constructed a hypothetical score for each issue on a four-point (0-3) Likert scale using each of the five materiality categories. These scores were then added together to give each issue an overall score of 0-15, with the higher scoring issues understood to be more material to the particular subsector. Although the scores presented here were not derived through a comprehensive and transparent assessment process that would ultimately be necessary, they are indicative of the kinds of ratings and rankings that might emerge.

Even under the most rigorous conditions, there will be limitations to such an approach:

- This method relies on subjective judgments for each category of analysis. Users must remind themselves that the numbers generated through this process rely on judgment both in development and in application.
- The five measurements of materiality listed above, though meant to capture a broad universe of stakeholder concerns, may still be overly focused on corporate performance as measured by managers and investors—that is, by what is material

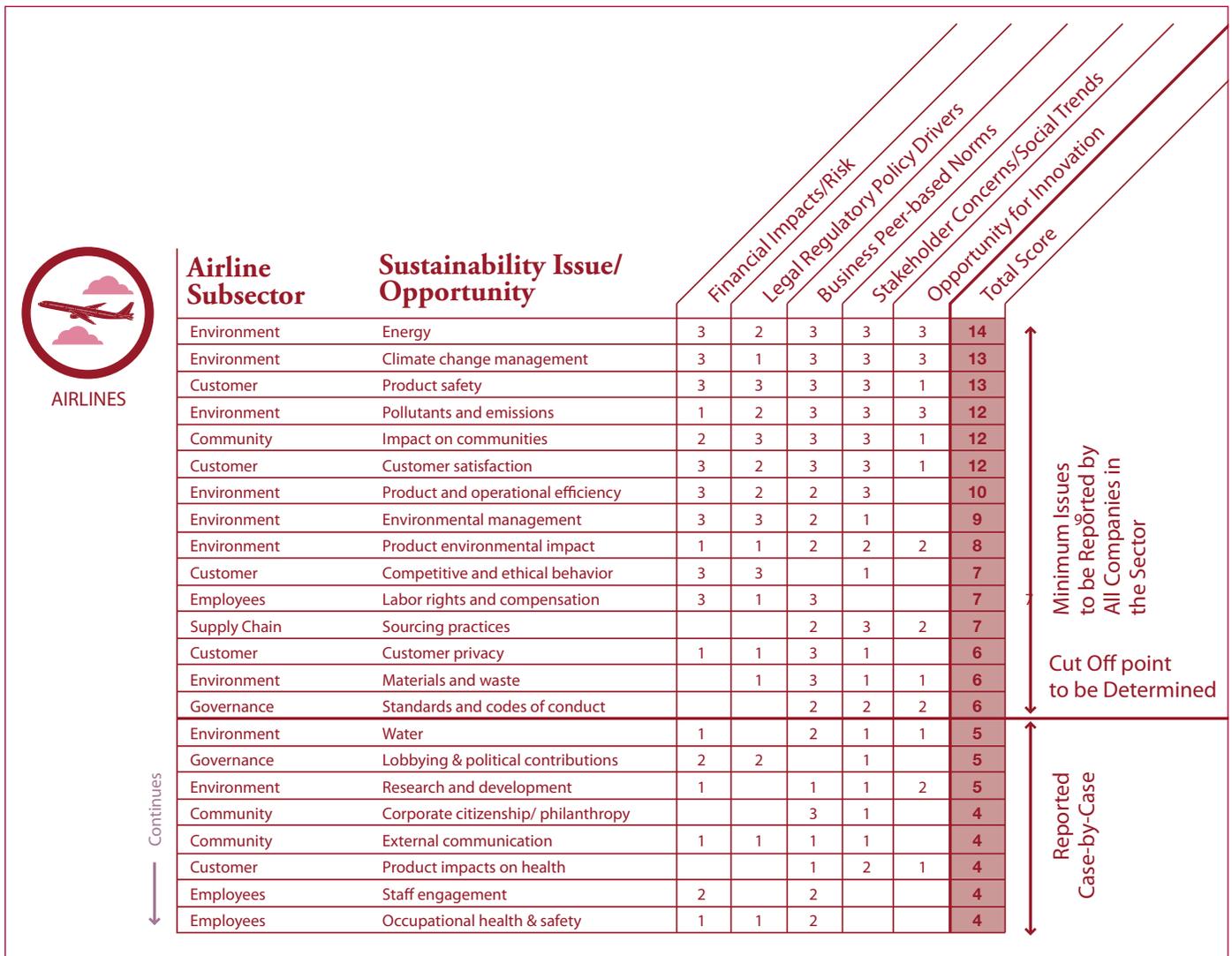
in the current financial system, rather than a system that is fully aligned with the creation of long-term wealth.

- The materiality tests must also balance the effects of outsized impact—for example, an overwhelming priority to product safety or supply chain management—with the inclination to weigh all five categories equally.

For this hypothetical exercise, we chose six specific industry subsectors as examples—airlines, automobiles, property-REITS, electric utilities and banks—to illustrate how the proposed process would lead to differentiated results.

Before testing the materiality of sustainability issues at a subsector level, it is important to translate these issues into meaningful ones for the subsector. This means identifying how each issue from the pool would apply to or manifest itself within the subsector, given the particular nature and context of that subsector. This process is an art more than a science, but is essential to achieving a sector-specific understanding of materiality.

For example, the universal pool of issues includes Community Impacts, which could refer to noise in the context of the airlines industry, but also refer to resettlement in the context of the mining industry. Similarly, Product Safety for the airlines industry refers to accidents/safety, whereas it could refer to product recalls for the food products industry.



The results of this exercise show that some issues are material across all six industry subsectors, and others are relevant only to a particular subsector. This exercise makes it possible to rank issues in terms of their materiality, helps stakeholders identify key issues, and allows corporations to efficiently allocate resources to those issues most relevant to their sustainability performance.

Step 5: Rank the materiality of these issues within an industry and establish a threshold that defines those issues that are key

Once the materiality tests have been applied to the broad set of sustainability issues and those issues ranked by their relative importance within a particular

Figure 4: Establishing the cut-off point for “minimum” materiality This figure shows a portion of the results of the materiality assessment conducted for the airlines subsection. Higher total scores indicate higher materiality relative to other issues the airline is facing. An appropriate cut-off point can be established based on the materiality score to determine the minimum issues to be reported by all companies in a subsector. Other issues would be reported on if an individual company determines that the issue is material to their stakeholders. These results are not definitive, but rather illustrative of the transparency of this method. Any stakeholder can see and comment on the relative significance of an issue with respect to other issues in the sector.

industry, a determination needs to be made as to where to draw the line in establishing material issues. (see the example in Figure 4).

Judgment is required here, but consistency in logic across sectors is also desirable. There are several logical approaches. One could take a particular score as the cut-off point– say, all issues that scored 10 or higher on the ranking system.

Alternatively, a set number of issues for all industry sectors could be chosen, say eight, and those top-eight ranked issues declared key. A third approach might be to select as key the top quartile (25%) scoring issues for any subsector. The greatest challenge in this step of the process is to assure that in the end the number of key indicators strikes an appropriate balance between manageability, comprehensiveness, and materiality in assessing a sector's ESG impacts.

The results of our exercise suggest that that the identification of a manageable, but reasonably comprehensive, set of key indicators might prove relatively simple.

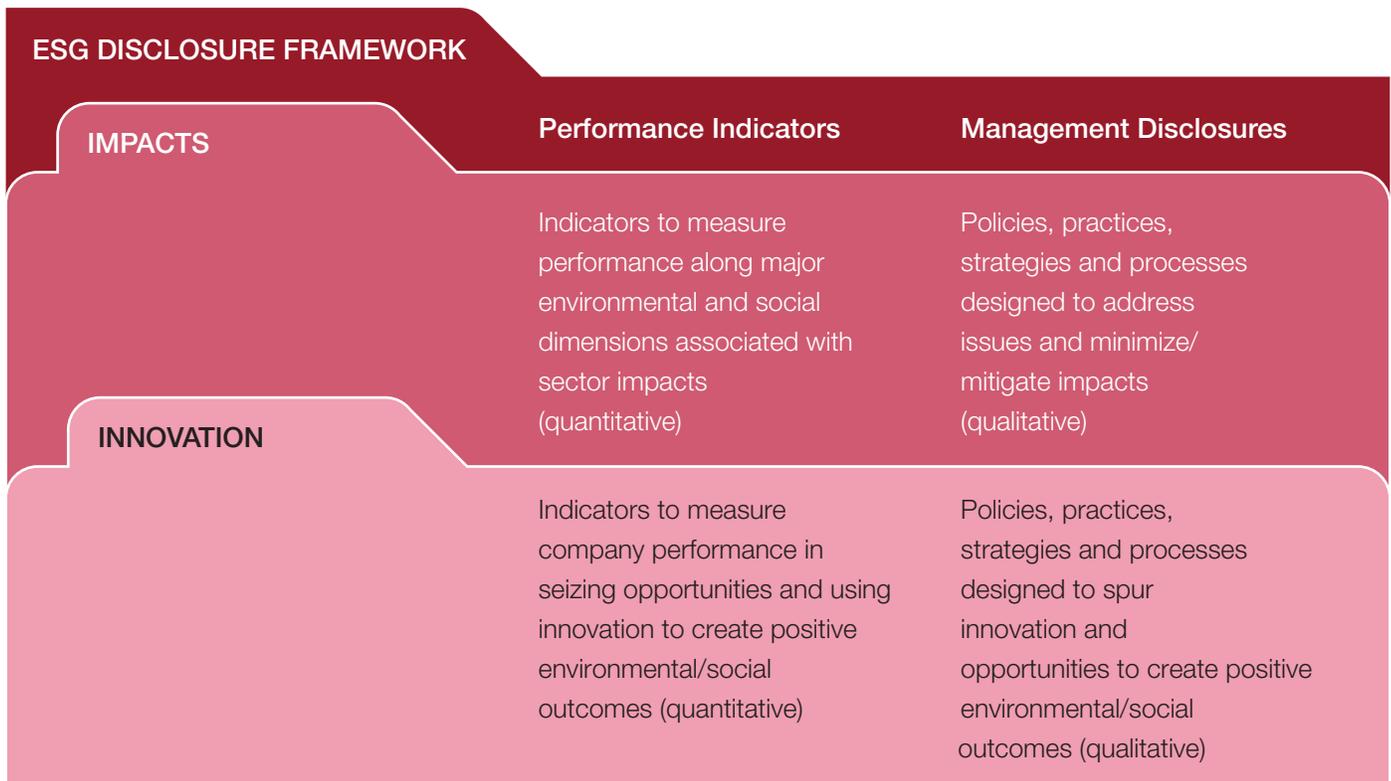
A review of the six industry examples in Appendix D reveals a fairly clear differentiation between those issues that score highly within a sector on the materiality test and those that do not. Again, our scores are not the result of the sort of thorough, multiparty process that a complete analysis would require, but they offer an indication of how the method would work.

Step 6: Create a tailored set of key performance indicators for the most material issues for each sector

In this final and perhaps most complicated step, it is necessary to translate the general sustainability issues into sector specific KPIs. For the purposes of this hypothetical exercise, we have chosen to define two differing types of KPIs and two methods of disclosure for each type.

We distinguish between KPIs that we call Impact indicators and what we call Innovation indicators (see Figure 5). The Impact indicators are corporate actions taken in the course of daily business operations that substantially impact stakeholders. These include environmental emissions, workplace safety records, community giving, product quality programs, policies on vendor labor standards, business ethics standards and public policy stands on climate change, among others.

The Innovation indicators relate to business model decisions such as the launch of new products or strategies that target major sustainability or social justice challenges of our times. These include decisions to enter the renewable energy or energy efficiency markets, to develop vaccines that prevent childhood disease in developing countries, to assure access to mobile phones for the rural poor, to encourage small-scale entrepreneurship as a marketing tactic for products in mature markets, or to



stress the benefits of healthy foods or lifestyles in product lines.

For each of these two sets of indicators, metrics can be developed that are either Performance Based or Management Oriented.

Performance Based metrics are typically quantitative, but backward looking. They report specific data on companies’ records either for key stakeholder issues—where the focus is often on risks avoided; or for key business strategies—where the focus is often on specific positive social and environmental outcomes in addressing sustainability challenges. They tend to be specific, measurable, comparable,

Figure 5: Framework for ESG key performance indicators and management disclosures Issues which are deemed to be material for the subsector are translated into indicators for reporting. Indicators are developed here using this framework which addresses ESG impacts as well as opportunities. The framework allows for indicators that are quantitative as well as qualitative. Quantitative indicators take the form of a comparable KPI, while qualitative indicators would become a management disclosure

reliable and capable of being reported in normalized formats.

Management Oriented metrics address these same issues, but capture general corporate policies and strategies, either as a proxy for performance or to provide additional context. They are generally reflective and qualitative, focusing on written policies, best practices, process innovations, and overall business strategies.

As an example, Figure 6 presents a summary of key performance indicators and management disclosures for the airlines subsector. This represents a complete set of guidance on material issues that could be given to the subsector, as a basis for minimum reporting requirements.

For a given material issue, appropriate metrics may reflect any combination of these two types of indicators and two types of disclosure. For example, within the airlines subsector that we analyzed, we found that:

- Energy (specifically, alternative fuels) was a material issue for which the most appropriate metric for disclosure was “research and development on alternative fuels.” (Innovation/Management Oriented)
- Product environmental impact (specifically, carbon emissions from flights) was a material issue for which the most appropriate metric for disclosure was “% carbon emissions per passenger miles flown.” (Innovation/Performance Based)

- Customer privacy was a material issue for which the most appropriate metric for disclosure was “policies and practices with respect to customer rights and privacy.” (Impact/Management Oriented)
- Operational efficiency was a material issue for which one of the most appropriate metrics for disclosure was “passenger load factor.” (Impact/Performance Oriented)

The six industry case studies demonstrate how this process might work in practice. We should emphasize here that these case studies are offered in the spirit of exploration and discovery and we make no claim to have identified the correct sets of industry key performance indicators.

|  | Airlines | Performance Indicators | Management Disclosures |
|---|------------|--|---|
| AIRLINES | Impacts | Scope 1 metric tons CO ₂ e emissions per 1000 revenue ton miles (RTM) | Labor relations and practices |
| | | Total scope 1 and 2 metric tons CO ₂ e, in millions | Policies and practices with respect to customer rights and customer privacy |
| | | Metric tons of Nox emissions per 1000 revenue ton miles | Systems for environmental management |
| | | Fuel efficiency: Gallons per RTM | |
| | | % of operating entities registered under IATA Operational Safety Audit | |
| | | Average number of flight hours logged per pilot | |
| | | Accidents per 100,000 departures | |
| | | % of flights arriving on time | |
| | | Customer complaints to DOT per 100,000 enplanements | |
| | | Total noise exceedances per 1000 operations | |
| | | Average age of fleet | |
| | | % of maintenance that is unscheduled | |
| | | Passenger load factor | |
| | | Number of notices of environmental violations or non-compliances | |
| | | Total number of days with worker strikes in US | |
| | Innovation | % of ground support equipment that is electric or certified as a low-emissions vehicle | Research and development on alternative fuels |
| | | % passenger miles offset through customer programs | Programs for customers with emergency travel needs |
| | | % of waste diverted from landfill | Carbon management strategy |
| | | | Carbon offset programs for passengers |
| | | | Sustainable purchasing policies |
| | | Commitment to sustainable operating practices | |

Figure 6: Key performance indicators and management disclosures: Guidance for airlines subsector This figure shows a hypothetical set of tailored performance indicators and management disclosures developed for the Airlines sector, as a basis for minimum reporting on material ESG factors for the sector. Minimum guidance such as this could be developed for all 114 ICB sectors, sending clear signals as to what matters with respect to ESG disclosure and performance.

Results from the Experiment

We undertook this thought experiment to envision a reporting method based on the straightforward propositions that:

- Key sustainability issues differ by industry sector;
- Those issues can be refined into a manageable bundle by sector;
- This process will advance our understanding of what a mandatory reporting regime that balances broad-based sustainability disclosure with KPIs would mean in practice.

The results confirm the validity of these propositions. Figure 7 compares the top issues (shaded) as determined by our materiality test for the six diverse industry subsectors that we evaluated as part of the experiment. The method leads to a relatively clear set of KPIs for each subsector, and the KPIs differ for each subsector. Note that there are differences both in the issues addressed and in the relative ranking of each issue. Once the issues are translated into indicators, however, the results are unique and highly relevant to the core activities of each sector (presented in Figures D1 through D6 in Appendix D).

We believe this experiment points in a fruitful direction for creating reporting regimes that balance the needs for simplicity, relevance, transparency, and comprehensiveness. Each set of sectoral indicators coheres into a reasonably robust view of its sustainability impacts and opportunities.

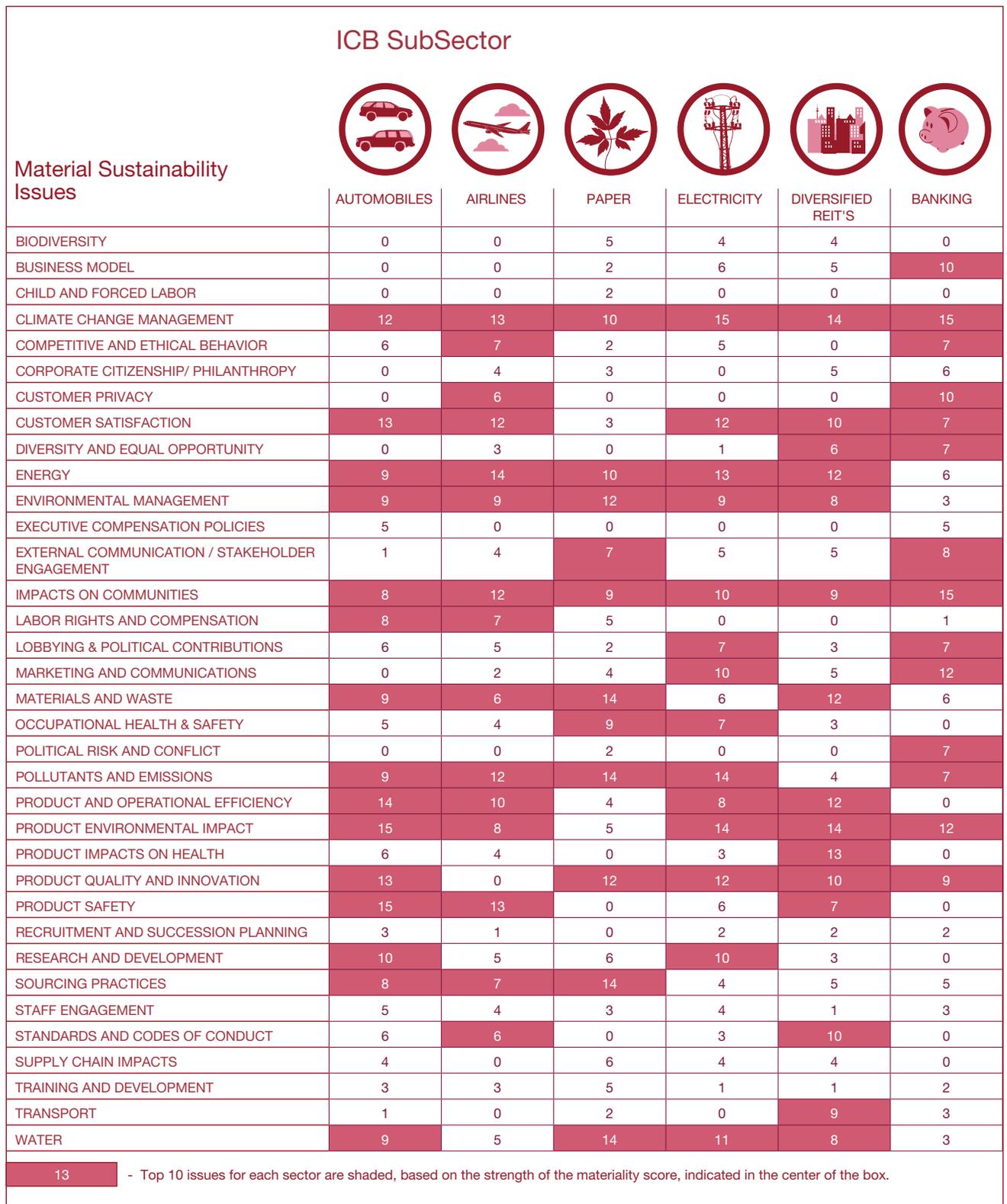


Figure 7: Material issues across the six subsectors This figure shows a hypothetical comparison of the most material ESG issues across the 6 subsectors analyzed. Highlighted issues are those that are most material in the subsector, as determined by their total score on the materiality test. Each issue varies in its materiality from sector to sector. While some issues are highly material to all sectors (climate change), other issues are unique to certain industries (customer privacy). This highlights the importance of a sector based approach to determining materiality from a broad universe of ESG issues.

This exercise also helps identify key issues that cut across multiple industries. The ten issues that cut across most of the six subsectors we evaluated were as follows (due to tied scores, the top ten actually spans 12 issues):

- Climate change management
- Energy
- Air quality and emissions
- Impact on communities
- Product and operational efficiency
- Product quality and innovation
- Product environmental impact
- Water
- Materials and waste
- Customer satisfaction
- Sourcing practices
- Environmental compliance

Over time, changes that occur in this common set of key sustainability issues can serve to track trends in stakeholder concerns, identify business model opportunities, and establish policy.

We should also note that, while a KPI approach identifies the most crucial sustainability indicators for a given industry at a given time, a broad-based universe of sustainability issues is necessary for successful maintenance and evolution of KPI reporting over time. These additional issues might at any given time be: material to narrowly defined stakeholder groups; leading indicators on emerging ESG issues; important insights into evolving management policies or practices; or factors simply unrecognized at the moment as material by stakeholders or regulators.

It is therefore crucial that both the development of universal issues, as defined by such organizations as the Global Reporting Initiative, and the development of key performance indicators by sector be encouraged.

Constructing an appropriate combination of broad-based issues and focused sustainability reporting is a major challenge faced by governments, stock exchanges and regulators as they tackle the important task of assuring that adequate ESG data is available to investors and society at large. How these authorities will handle this challenge, and in particular how they will balance the need for mandatory disclosure with the virtues of voluntary reporting, remains to be seen.

Over time, we expect these reporting regimes will lead to a convergence of the standardized financial reports of today with voluntary ESG reporting as it is currently practiced. (see Figure 8, next section, for an illustration of how these key indicators might become standard metrics to compare corporate performance, much like earnings-per-share).

Ideally, a routine inquiry into the sustainability fundamentals of a particular company could result in peer-to-peer comparisons of the intensity of a corporation's current impacts and its relative positioning to capture future opportunities. A world with mandatory reporting on sector-specific KPIs will allow fundamental insights into the most crucial aspects of corporations' relationships with society and the environment.

With mandatory reporting on ESG KPIs, a routine inquiry into the sustainability fundamentals of a particular company could result in peer-to-peer comparisons of the intensity of a corporation's current impacts and its relative positioning to capture future opportunities.



Sustainability Fundamentals:

[Lookup Symbol](#)

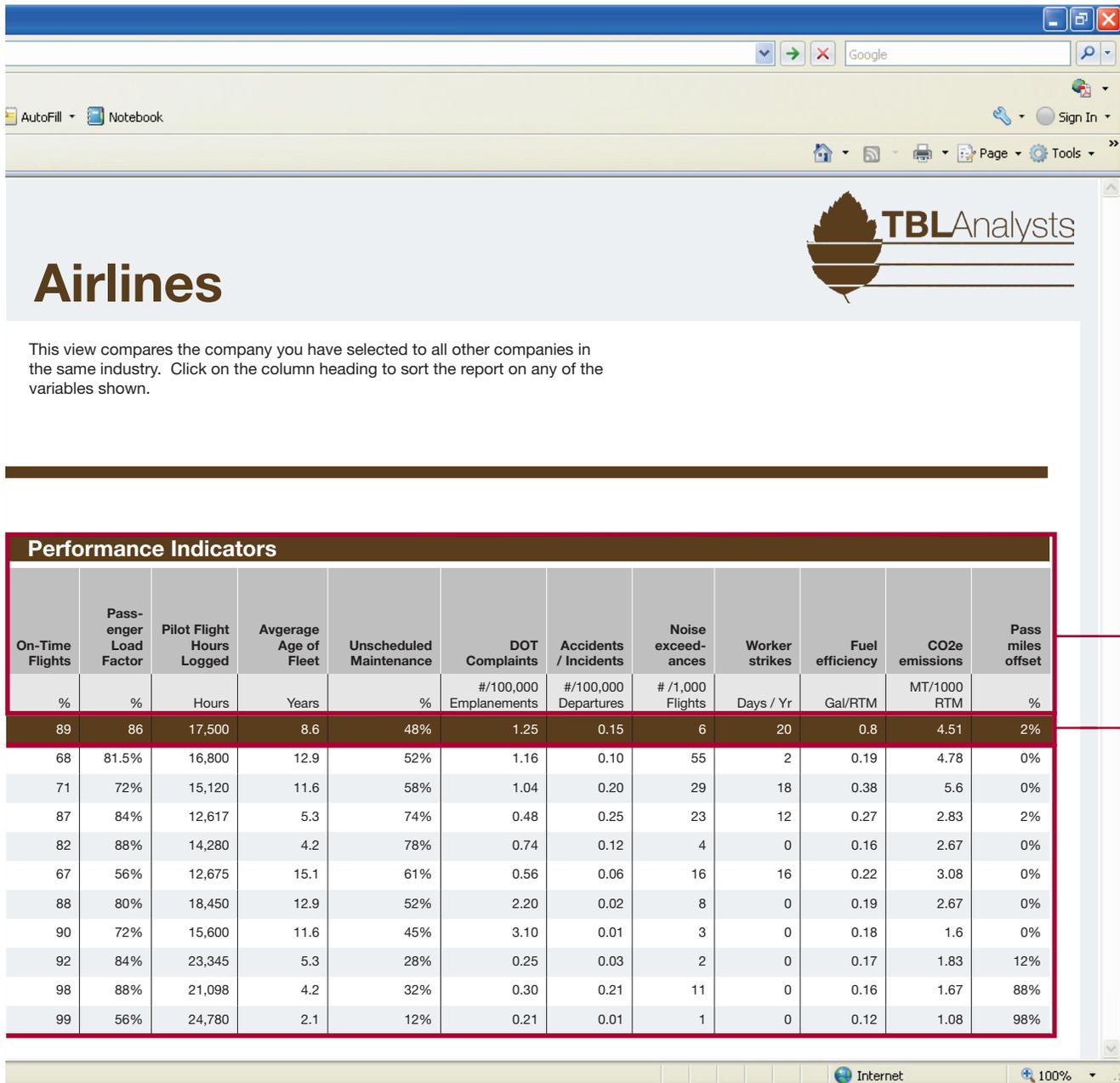
Impacts
Opportunities

| Profiling Indicators | | | | | | |
|----------------------------|--------------------------|------------|---------|--------|-----------|--|
| Annual Passenger air miles | Annual Revenue ton miles | Fleet Size | Revenue | Profit | Employees | |
| M Miles | RTM | # Planes | \$ M | \$ M | # | |
| 148,009 | 15,989 | 801 | 18,034 | 121 | 25,000 | |

| Industry Average | |
|------------------|-------------------|
| ▶ TRA | TruAir |
| PLA | Plateau Airlines |
| ABL | Air Blanc |
| GS | GreenSky |
| CJT | CayJet |
| BAIR | BelAir |
| OJT | OffsetJet |
| OPF | One Planet Flying |
| SUSJ | SusJet |
| NLN | New Line |

| | | | | | |
|---------|--------|-------|--------|-----|--------|
| 141,287 | 16,860 | 892 | 22,935 | 21 | 16,000 |
| 127,158 | 15,174 | 803 | 20,642 | 32 | 25,000 |
| 57,928 | 6,913 | 366 | 9,403 | 207 | 38,000 |
| 98,907 | 17,197 | 624 | 18,348 | 514 | 55,000 |
| 165,306 | 19,726 | 1,044 | 14,726 | 590 | 98,397 |
| 213,927 | 25,528 | 1,351 | 34,727 | 347 | 10,000 |
| 142,321 | 17,432 | 752 | 21,658 | 280 | 63,000 |
| 56,789 | 9,643 | 341 | 9,304 | 702 | 35,670 |
| 97,823 | 18,547 | 234 | 54,980 | 650 | 32,000 |
| 156,342 | 19,098 | 789 | 38,098 | 890 | 12,000 |

Peer Comparison
Complete Data Set
Normalizing Factors



Benchmarking

Consistent Units

Figure 8: KPI's in practice - comparable and complete data set Illustrated here is a hypothetical preview of what mandatory reporting against performance indicators by every company in the sector could lead to in the future—the ability to benchmark corporate performance along the triple bottom line, and determine sector norms. This type of insight can lead to companies competing on ESG performance, and entire sectors moving in a more sustainable direction.

3

Conclusion and Recommendations

Conclusion and Recommendations

In writing this paper, we have reached a number of conclusions about key performance indicators and methodologies:

- Key performance indicators can play a vital role in any sustainability disclosure scheme.
- A method for identifying KPIs for all industry sectors that is simple, material and transparent can be developed and implemented with a reasonable degree of up-front effort.
- KPIs are most useful when they are specific to industry subsectors.
- Substantial work has already been done in identifying a broad universe of issues that are fertile ground for identifying key issues for a given industry sector.
- Substantial work has already been done in defining criteria for the materiality of potential key issues.
- Substantial work has already been done in defining industry subsectors that will be useful in identifying comparable KPIs.
- Additional work needs to be done to identify the most material KPIs to support comparability in industry subsectors.
- KPIs can be usefully related to the key impacts of sectoral activity and the opportunities for new business strategies and models.
- Reporting on KPIs can be performance based (quantitative) or based on management policies and business processes (qualitative).
- Certain key issues are common to many industry sectors, while others are unique to a particular sector.
- Transformation of relevant issues to sector-specific indicators is a critical step in developing KPIs that are relevant to business

- Any method for identifying and reporting on KPIs needs to be flexible, because KPIs will vary from industry to industry, from country to country, region to region, and from time to time.
- Increased uptake in voluntary reporting, with a move towards mandatory reporting on a basic set of KPIs is ultimately necessary to fill varying disclosure needs of our diverse societies and complete the convergence of financial and sustainability reporting.

Because sustainability disclosure is useful to governments and societies as they manage the impacts of corporations, we recommend that government regulators, stock exchanges, responsible investors, nongovernmental organizations, accounting firms, and related parties concerned with the best way to increase the availability of corporate ESG data, cooperate in the development of a full-blown method and governance structure for identifying and providing guidance to corporations regarding KPIs.

By establishing mandatory reporting on sustainability KPIs for publicly traded corporations in the United States, competition on important dimensions of sustainability can be encouraged and entire industry sectors channeled towards the creation of a more just and sustainable society.

Endnotes and Resources

Endnotes

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A

Appendix A
GRI & Industry KPI Method:
A Complementary Approach

Appendix A

The mission of the Global Reporting Initiative (GRI) is to encourage a broad range of organizations (including government agencies, publicly-traded and privately-held corporations, and small and medium enterprises) to publicly disclose their sustainability performance. The most recent version of GRI's reporting standards—the G3 Guidelines—calls for organizations to adhere to reporting principles that help to appropriately define the content of the report and its quality. The G3 reporting system includes: Guidelines with reporting principles, guidance, standard disclosures and indicators; Protocols explaining how to calculate performance; and Sector Supplements that provide unique indicators for a number of sectors. GRI would also like to see National Annexes developed to capture sustainability issues that are particular to a country or region.

The primary difference between the industry-specific KPIs proposed here and the GRI indicators relates to the question of materiality. GRI has identified a broad universe of sustainability indicators through a rigorous multi-stakeholder process, but leaves to individual companies the conducting of materiality tests to determine which indicators to report on. Under the KPI approach proposed here, a third party would identify indicators that represent the greatest material impacts and opportunities for a particular sector, as a starting point.

The materiality indicators would be developed through a transparent process that involves input from stakeholders and sector specialists. This would provide a minimum level of material issues which all companies in the sector would be required to disclose. Additional disclosure for material issues relevant to a company's particular situation would remain the responsibility of individual companies.

The comprehensive universe of GRI sustainability issues can serve well as a starting point for determining relevant sector specific KPIs.

However, the G3 indicators are generally applicable and a tailored approach is needed to identify crucial, unique sector-specific indicators which the GRI does not address. Similarly, the management disclosures advocated by GRI can be used as a basis for industry-based management disclosures.

The GRI has prepared a number of industry-specific sector supplements. These sector supplements vary in quality and approach. While some address sector specific issues, others identify which of the generic issues are most relevant to that sector. Where available, these sector supplements help to focus attention on a more limited data set than called for in the GRI general guidelines.

It should be noted that mandatory guidance on sustainability KPIs by sector would not relieve companies from the need to determine additional material information that should be disclosed. Rather, this system would identify a minimum set of specific sustainability indicators required for the sector as a whole. Full disclosure may require reporting on a range of issues that go beyond sector-specific indicators.

A US GRI National Annex

The introduction of mandatory sustainability reporting may catalyze further uptake of the GRI framework, both as a means for companies to distinguish their sustainability practice, and as a way for companies to adopt a holistic approach to the sustainability issues identified by mandatory KPIs. In the future, industry-based indicators for US publicly-traded companies could serve as the basis for a US National Annex that is adopted into the GRI reporting system. Industry-based indicators could also help to inform GRI’s continuing work as it continues to develop Sector Supplements.

Table A1 highlights the fundamental differences between the GRI approach and the proposed sector-specific KPI approach. GRI emphasizes disclosure (reporting on many issues in order to be transparent). Our proposed KPI approach emphasizes performance (reporting only the most material things that can be managed to improved outcomes).

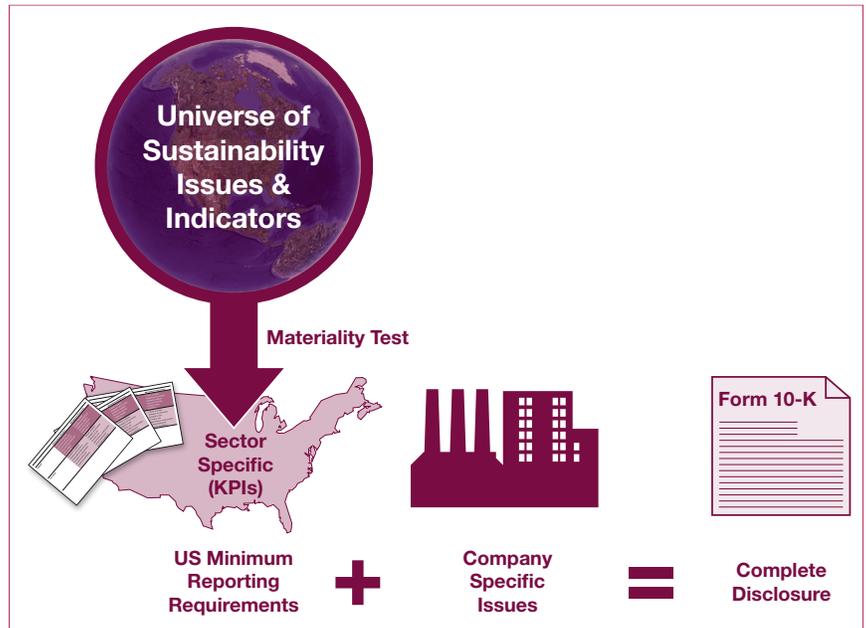


Figure A1: Proposed relationship between minimum ESG disclosure requirements and complete disclosure in a company’s Form 10-K.

| Sustainability Reporting System | Components | Reporting Requirements | # of Indicators and Sources | Prioritization |
|---|--|---|---|---|
| GRI Approach | Guidance, Principles of Reporting, Indicators, a few Sector Supplements and national annexes | Voluntary | 79 indicators covering a range of economic, environmental and social issues. Developed through global, multi-stakeholder process | Reporting companies undertake their own materiality test or other process to select indicators |
| Sector KPIs <i>(Proposed Approach)</i> | Subsector-specific indicators and management disclosures for all industries in ICB classification system | Mandatory for all companies within a sector | KPIs for each sector addressing impacts and opportunities specific to US context. Uses GRI indicators as a basis, but tailored for US market and industries by a designated authority | KPIs have already been prioritized on the basis of materiality to the sector. Fully transparent. Results publicly disclosed and open to stakeholder input |

| Responsibility for Determining Materiality | Integration with Financial Reporting | Comparability | Success defined as... | Outcome |
|---|---|----------------------|---|---|
| Reporter selects a reporting level and determines which indicators to report on | At the discretion of the filer | Sometimes | Best report - in terms of disclosure, transparency and reporting process | Potential to build trust and accountability with stakeholders (one company at a time) |
| Mandatory indicators to be established by an organization authorized by SEC, such as a Sustainability Accounting Standards Board. Minimum materiality | Always fully integrated. Form 10-K format for disclosure. | Yes, within a sector | Best performance - in terms of continued improvement with respect to KPIs | Potential to move markets (entire sectors begin to compete on KPIs, focusing on impacts and innovation) |

Table A1: GRI vs. Industry-specific KPIs A comparison of the GRI approach to sustainability vs. our proposed sector-specific KPI approach yields important insights regarding the objective of disclosure. While GRI has made tremendous progress in encouraging more and better disclosure, what is urgently needed, and can be delivered with a KPI approach, is better performance on the things that matter most.

B

Appendix B
Sustainability Reporting
Laws and Practices

Appendix B

Sustainability reporting has already been addressed in one form or another in a number of countries around the world. Differences between the historical relationship between government and corporations, the regulatory environment, and cultural and societal norms have led to a variety of approaches in different regions.

THE WORLD'S SOCIAL REPORTING LAWS²⁴

Sweden: By 2009, state-owned companies will be required to produce annual sustainability reports in accordance with Global Reporting Initiative (GRI) G3 guidelines.

France: Since 1977, companies with more than 300 employees have been required to file a “bilan social”, reporting on 134 labour-related indicators. The 2001 New Economic Regulations Act further requires listed companies to disclose data on 40 social and environmental criteria in their annual reports.

UK: Under the 2006 Companies Act, companies listed on the London Stock Exchange have to report on non-financial issues relevant to their business within annual reports.

Germany: Since 2004, companies have been required to report within annual reports on key non-financial indicators that materially affect their performance.

US: There is little regulation on sustainability reporting, apart from rules regarding hazardous waste and toxic chemicals disclosure and governance disclosures required by the Sarbanes-Oxley Act. The New York Stock Exchange requires listed companies to publish a code of business conduct and ethics.

Japan: Under a 2004 law, certain companies and government agencies are required to produce annual reports on environmental impacts.

China: The state-owned Assets Supervision and Administration Commission issued a directive in January 2008 encouraging state-owned companies to report on responsible business activities.

Malaysia: From 2007, the government has required all listed companies to publish corporate social responsibility information in their annual reports

The pace at which governments and stock exchanges have adopted measures requiring or encouraging disclosure on non-financial issues is increasing. The growing scientific consensus on the impacts of global warming, the emergence of institutional investors that apply socially responsible investment criteria, and the increasing weight given to social and environmental factors in assessing the social and environmental risks of corporations have all contributed to this trend.

Many governments believe they have a clear and direct interest in sustainability reporting. They are acting on the belief that comprehensive sustainability reporting can help markets function more efficiently by providing material social and environmental information, and can help move all organizations toward government-mandated sustainable development goals.

C

Appendix C
Review of Sustainability
Reporting Frameworks

Appendix C

We reviewed a range of sustainability reporting frameworks—including those promoted by companies, investors, rating agencies, information providers, research organizations, and other stakeholders—to examine how industry best practice might best be applied in the United States. These frameworks either 1) explicitly advocate reporting on certain social and environmental issues or 2) imply the need for their disclosure since they include them in their analysis of corporate performance.

Findings

- 1 A wide range of organizations have called for the disclosure of, or explicitly make use of, social and environmental indicators:
 - Institutional investors increasingly collaborate to promote greater disclosure to help improve investment decision-making. The Investor Network on Climate Risk is an example of one such coalition.
 - Research and rating agencies increasingly seek data to help them evaluate the sustainability performance of corporations. Their evaluations are marketed widely in the financial community for use in implementing the responsible investment policies of a wide variety of investors. EIRIS and Jantzi-Sustainalytics are examples of two such rating agencies.
 - Asset managers specializing in responsible investment often advocate increased disclosure. In the United States, Calvert, Pax World and Domini Social Investments are examples of managers with a primary focus on socially responsible investment.

- Professional bodies, research institutes, and advocacy organizations promoting increased social responsibility among corporations often call for increased disclosure. The CFA Institute Centre for Financial Market Integrity, the Initiative for Responsible Investment, and Oxfam are examples of such organizations.
- 2 Most frameworks have been developed through collaborative processes.
 - 3 GRI's G3 has been widely adopted as the de facto standard for reporting across a range of industries.
 - 4 Some reporting initiatives focus on single-issues which are not being adequately discussed in sustainability reports. The Carbon Disclosure Project is an example of one such initiative.
 - 5 Adequate evaluation corporate social and environmental performance will require additional information about how social and environmental issues are managed, how performance compares to appropriate benchmarks, what targets have been set for KPIs and how companies have performed against targets.
- 6 The perspective taken by the organizations reviewed reflects an interest in one or more of the following:
 - Transparency and public disclosure
 - Management of ESG risks
 - Performance results
 - Capacity to manage sustainability issues
 - Value creation
 - 7 Evaluating a company's ability to seize opportunities and innovate for sustainability is emerging as an issue that can distinguish sustainability leaders.
 - 8 Users of sustainability data agree there is still a general lack of comparability as companies have the flexibility to select what indicators to report on and the format in which to report.

9 Analysts do not have sufficient information to understand how non-financial reporting should be considered when evaluating investment prospects; at the same time, there is acknowledgement that traditional financial reporting does not capture the intangibles that are responsible for 80% of company value. The Enhanced Business Reporting Consortium (EBRC) and Gartner have collaborated, for example, on an initiative to identify the industry-specific, non-financial business metrics that are most important to financial investors. The International Corporate Governance Network meanwhile is calling for companies to be more selective in determining what non-financial information they report on and to indicate to investors non-financial issues are linked to corporate strategy.

10 While most organizations publicly disclose the information they track, rating agencies and information providers tend to keep the information private.

The wide range of indicators and issues being tracked by multiple organizations suggests there is a significant duplication of efforts arising from a lack of clarity on what issues are most material or relevant for non-financial reporting.

The lack of standards and minimum reporting requirements by sector results in unique, non-comparable reports. Contrast this to the state of financial reporting (see Figure C1) in which comparable financials result in the ability to publicly benchmark and compare performance, albeit against a single bottom line. The ability to benchmark sustainability performance that could arise from mandatory minimum reporting requirements could prove to be an essential element in facilitating the movement toward competition on sustainability, in addition to financials.

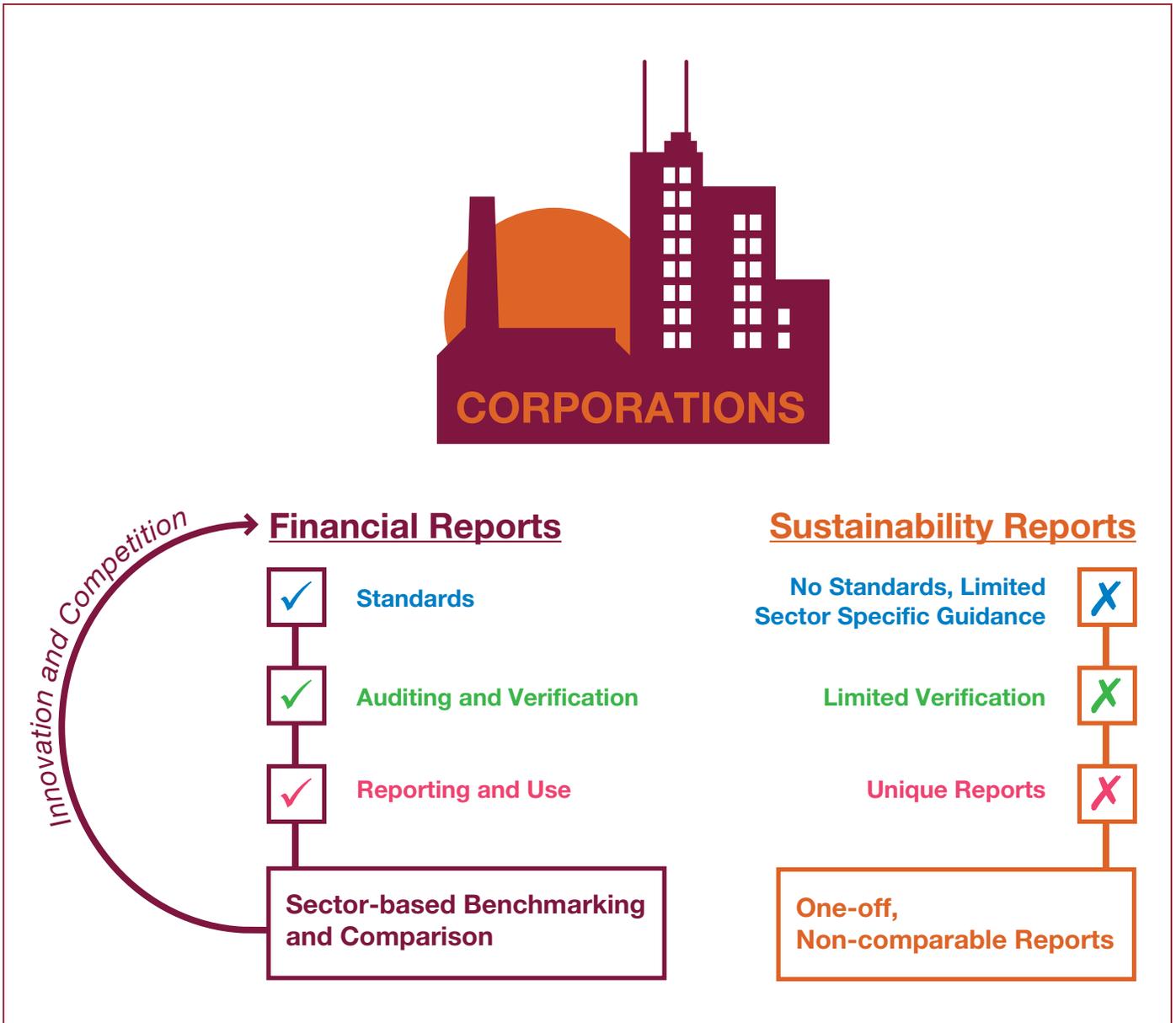


Figure C1 Financial vs. Sustainability Reporting

Key differences in standards, verification and reporting for the current state of financial vs sustainability reporting

D

Appendix D
Sustainability Indicators for
Six ICB Subsectors Reviewed

Appendix D



| Airlines | Performance Indicators | Management Disclosures |
|--|--|--|
| Impacts | Scope 1 metric tons CO2e emissions per 1000 revenue ton miles (RTM) | Labor relations and practices |
| | Total scope 1 and 2 metric tons CO2e, in millions | Policies and practices with respect to customer rights and customer privacy |
| | Metric tons of Nox emissions per 1000 revenue ton miles | Systems for environmental management |
| | Fuel efficiency: Gallons per RTM | |
| | % of operating entities registered under IATA Operational Safety Audit | |
| | Average number of flight hours logged per pilot | |
| | Accidents per 100,000 departures | |
| | % of flights arriving on time | |
| | Customer complaints to DOT per 100,000 enplanements | |
| | Total noise exceedances per 1000 operations | |
| | Average age of fleet | |
| | % of maintenance that is unscheduled | |
| | Passenger load factor | |
| | Innovation | % of ground support equipment that is electric or certified as a low-emissions vehicle |
| % passenger miles offset through customer programs | | Programs for customers with emergency travel needs |
| % of waste diverted from landfill | | Carbon management strategy |
| | | Carbon offset programs for passengers |
| | | Sustainable purchasing policies |
| | | Commitment to sustainable operating practices |

Figure D1 Sustainability Guidance: Key Performance Indicators for Airlines Subsector
Impact/Innovation indicators for the most material issues in Airlines Subsector



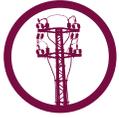
| Automobiles | Performance Indicators | Management Disclosures |
|-------------------|---|--|
| Impacts | Corporate Average Fuel Economy (CAFE) in miles per gallon | Policies regarding closure of facilities, including retraining of labor |
| | Average National Highway Traffic Safety Administration (NHTSA) star rating of fleet, weighted by sales | |
| | Industrial Emissions of CO2e in tonnes per unit produced (t/unit) | |
| | Annual Scope 1 and 2 emissions of CO2e (metric tons) | |
| | Volatile organic compounds (VOC) per unit produced, kg/unit | |
| | Energy consumed per unit produced, in MWh unit | |
| | Water used per unit produced, in gallons/unit | |
| | Total waste per unit produced (Kg/unit) | |
| | Number of U.S. units recalled in millions of units | |
| | Number of incidents of non-compliance with environmental regulations. | |
| | Total number of days with worker strikes in US | |
| Innovation | % energy supplied from renewable sources | Commitments to reduce GHG emissions of industrial operations |
| | % water from non-potable (recycled) sources | Commitments and efforts to improve vehicle efficiency, safety, and performance, including R&D spending |
| | % waste from operations diverted from landfills, excluding hazardous waste | Policies regarding product take back and design for recyclability, and end of life management |
| | Amount of recyclable materials in fleet (as % of vehicle weight) | Efforts to reduce total cost of ownership for consumer for all models |
| | Fuel efficiency in miles per gallon of most efficient model to best selling model (based on EPA combined fuel economy for city and highway) | Efforts to maintain residual value of models |
| | Percentage of latest model year fleet that achieves a score of 7 or more on the EPA Air pollution score, weighted by sales | Policies regarding environmental and social standards for suppliers |
| | Percentage of fleet that scores 80% or more on the Consumer Reports reliability ratings | |
| | % of Manufacturer's Suggested Retail Price maintained after two years of ownership, for best selling model | |

Figure D2 Sustainability Guidance: Key Performance Indicators for Automobiles Subsector
Impact/Innovation indicators for the most material issues in Automobiles Subsector



| Commercial Banking | Performance Indicators | Management Disclosures |
|--------------------|---|---|
| Impacts | % investments evaluated for climate change risk | Policies and processes to manage climate change risk |
| | Loans as a % of deposits within low/moderate income communities | Efforts to attract a diverse customer base |
| | % bank branches located in low to moderate income neighborhoods | Programs and expenditures on financial literacy |
| | % lending to micro, small and medium size businesses | Policies and processes for assessing and screening environmental and social risks |
| | Community Reinvestment Act (CRA) Rating | Policies to protect customer privacy |
| | Number of customer privacy and security complaints per 1000 customer accounts | Polices regarding human rights |
| | % of operating revenue from fees | Polices regarding ethics |
| | Number of complaints about unfair fees and lending practices per 1000 customer accounts | Polices and spending on political contributions and lobbying |
| | Overall customer satisfaction rating according to J.D. Power and Associates Retail Banking Study | |
| | % board members that are women or minorities | |
| | % senior managers that are women or minorities | |
| | CO2e emissions in kg per square foot | |
| Innovation | Adoption of the Carbon Principles | Products and services to support environmental initiatives |
| | % lending screened on social, ethical and environmental grounds | Outreach practices with community groups |
| | Value of lending for projects and businesses associated with environmentally or socially beneficial focus (\$billion) | |

Figure D3 Sustainability Guidance: Key Performance Indicators for Banks Subsector
Impact/Innovation indicators for the most material issues in Banks Subsector



| Conventional Electricity | Performance Indicators | Management Disclosures |
|--------------------------|---|--|
| Impacts | Metric tons of CO2e per KWh for scope 1 emissions | Management of climate change risk and efforts to reduce GHG emissions |
| | Metric tons of mercury emissions per million GWh | Long-term energy supply planning and efforts to diversify supply |
| | Metric tons of NOx per KWh | Efforts to ensure compliance under RPS and RGGI |
| | Metric tons of SO2 per KWh | Efforts to minimize/prevent impacts to local communities |
| | Ranking in J.D. Power and Associates Electric Utility Business Customer Satisfaction Study | Efforts to ensure utility can continue to comply with current and emerging reliability standards |
| | Ranking in J.D. Power and Associates Electric Utility Residential Customer Satisfaction Study | Contributions to political campaigns, candidates and PACs |
| | Number of outages per million MWh supplied | |
| | Transmission and distribution losses % | |
| | Annual infrastructure renewal and replacement rate (as % of base assets) | |
| | Number of notices of environmental violations or non-compliances | |
| | Residential average electricity rate \$/KWh | |
| | Severity Rate: Number of days away from work, per 100 employees, as a result of work-related injuries or illnesses. | |
| | Fatalities: Number of fatal occupational injuries | |
| | Liters of water used for processing, cooling and consumption per MWh | |
| Innovation | % energy supplied from renewable sources | Efforts to develop a smart grid and smart metering systems |
| | Dollar value of R&D spending on carbon sequestration, renewable energy and energy efficiency | Public education and communication programs |
| | Annual reduction achieved in thousands of KWh due to energy efficiency and demand reduction programs | |
| | % customers participating in green power market | |
| | Distributed generation capacity within customer base (MW) | |
| | % water from non-potable (recycled) sources | |

Figure D4 Sustainability Guidance: Key Performance Indicators for Conventional Electricity Subsector
Impact/Innovation indicators for the most material issues in Conventional Electricity Subsector



| Paper | Performance Indicators | Management Disclosures |
|-------------------|---|---|
| Impacts | Waste produced in kg per metric tonne of production | Major disputes and litigations regarding impacts on the environment and communities |
| | US Toxic Release Inventory, total onsite and offsite release and transfers from manufacturing facilities, in metric tonnes per 1000 tonnes production | Efforts to minimize odor impacts on local communities |
| | Dioxin and dioxin-like compounds releases, grams per million metric tonnes of paper production | Community relations and communications practices |
| | Water demand in cubic meters per metric tonne of paper production | |
| | Number of notices of environmental violations or non-compliances | |
| | % of industrial facilities certified under ISO 14001 | |
| | Total CO2e emissions (scope 1 and 2) kg per metric tonne of production | |
| | Energy consumption, BTUs per metric tonne of paper production | |
| | Severity Rate: Number of days away from work, per 100 employees, as a result of work-related injuries or illnesses. | |
| Innovation | % waste from operations diverted from landfills, excluding hazardous waste | Commitment to Chain of Custody certification |
| | % of paper products sold that includes at least 25% of post consumer recycled content | Policies regarding wood sourcing, including commitment to sourcing from FSC-certified forests |
| | % of pulp processes that use elemental chlorine-free bleach | Commitment to adopting environmental mgmt systems |
| | % water from non-potable (recycled) sources | Programs to reduce GHG emissions from manufacturing |
| | % of paper products that has chain of custody certification, by weight | |
| | % of wood that is sourced from third-party certified forests, by weight | |
| | % energy used in manufacturing from renewable sources | |

Figure D5 Sustainability Guidance: Key Performance Indicators for Paper Subsector
Impact/Innovation indicators for the most material issues in Paper Subsector



| Diversified REITs | Performance Indicators | Management Disclosures |
|-------------------|---|--|
| Impacts | Average CO2 emitted by portfolio properties in metric tons per 100 square feet per year | Policies and strategies to identify, evaluate and mitigate climate change risks to portfolio |
| | Total CO2 emissions in metric tons across portfolio | Policies and practices for addressing indoor environmental/ health contaminants |
| | % top executives and property managers that are women/minorities | |
| | Average energy use of buildings in portfolio (kW-h /sq ft) | |
| | Average Energy Star rating of portfolio | |
| | Waste generated from buildings in portfolio, lb/yr/ occupant | |
| | Average water use (gallons/day/occupant) | |
| Innovation | % commercial properties with access to wellness facilities | Policies for selecting, training and evaluating property managers with respect to sustainability credentials |
| | % commercial properties with access to daycare | Monitoring and reporting systems for tracking sustainability performance of portfolio |
| | % renewable energy, as % of total energy consumption | Commitments or policies for community engagement and good neighbor practices |
| | % properties with tenant submetering | Commitments or policies for attaining green building certification of existing and new properties |
| | Average % waste diverted from landfills from buildings in portfolio during operation | Policies to encourage and finance regular commissioning of energy, water and life safety systems |
| | Dwelling units per acre, average across portfolio | Policies and programs for risk management, disaster resiliency and life safety |
| | % properties located on infill or brownfield site | Commitment to implementing Principles for Responsible Property Investing, including signatory status |
| | Sq. ft. of properties with LEED or other third party certification | |
| | % properties that are employing green leases with majority of tenants | |
| | % properties located in areas with good transit accessibility | |
| | % recycled water use, on average, in buildings in portfolio | |

Figure D6 Sustainability Guidance: Key Performance Indicators for Diversified REITs Subsector
Impact/Innovation indicators for the most material issues in Diversified REITs Subsector

E

Appendix E
Integrated Financial Reporting

Appendix E

Shown in Figure E1 is a hypothetical example from the airlines subsector showing how a mandatory sustainability reporting system could be integrated into the Form 10-K report. The first section presents the results for KPIs, with explanatory notes, followed by management disclosures. Management disclosures will necessarily be a key component of a mandatory framework for sustainability reporting because they can address general issues relating to policies, practices, processes, and monitoring systems. They can also provide important context for understanding sustainability performance.

Example of integrated ESG Reporting

Form 10-K
Part V
Item 16. Environmental, Social & Governance Disclosures

Company: GreenSky Incorporated
ICB Subsector: 5751 Airlines
Year of Data (unless otherwise noted): 2009

(a) Environmental, Social & Governance Performance

(1) Summary of Performance Results

| Performance Data (2009) | | GreenSky |
|-------------------------|---|----------|
| Impacts | Scope 1 metric tons CO2e emissions per 1000 revenue ton miles (RTM) | 1.67 |
| | Total scope 1 and 2 metric tons CO2e, in millions | 29.6 |
| | Metric tons of Nox emissions per 1000 revenue ton miles | 0.031 |
| | Fuel efficiency: Gallons per RTM | 0.16 |
| | % of operating entities registered under IATA Operational Safety Audit | 100% |
| | % of flights arriving on time | 82% |
| | Customer complaints to DOT per 100,000 enplanements | 0.74 |
| | Total noise exceedances per 1000 flight operations | 4 |
| | Average age of fleet | 6.7 |
| | Average number of flight hours logged per pilot | 14,280 |
| | Total number of days with worker strikes in US | 12 |
| | % of maintenance that is unscheduled | 78% |
| | Number of notices of environmental violations or non-compliances | 2 |
| | Passenger load factor | 88% |
| | Accidents/incidents per 100,000 departures | 0.27 |
| Innovation | % of ground support equipment owned by airline that is electric or certified as a low-emissions vehicle | 76% |
| | % of waste diverted from landfill | 54% |
| | % passenger miles offset through customer programs | 9.2% |

Figure E1 (page 1 of 3)
Example of Integrated Reporting: Sustainability Reporting as part of Form 10-K Report Example of how a hypothetical airline company could report on performance indicators and management disclosures as part of an integrated Form 10-K Report. This example takes the Sustainability guidance (Figures D1 through D6) and demonstrates how a company would apply it to achieve concise integrated reporting. Reports would be simple, concise, transparent and comparable. Each company's Form 10-K would contain the minimum reporting on material ESG issues for their declared sector(s).

**Figure E1 (page 2 of 3)
Example of Integrated
Reporting: Sustainability
Reporting as part of Form
10-K Report**

Example of integrated ESG Reporting (continued)

(2) Exceptions and Notes to Performance Results

Waste data is for 2009 and covers only waste generated within Green Sky facilities in our two hubs.

(b) Additional Management Disclosures

(1) Labor relations and practices

One of the factors that differentiates our airline is the caliber of service provided by our staff. We hire only the best and reward our staff accordingly through benefits and compensation packages and stock ownership plans. We support our employees through flexible work hours, initial paid training, allowances and benefits. We also provide extensive safety and service training for our pilots, flight attendants, technicians, airport agents, dispatchers and reservation agents as well as leadership training for all supervisors and managers. Our employees consistently show the highest rates of satisfaction in the industry. Due to our excellent relations, none of our employees are unionized.

(2) Policies and practices with respect to customer rights and customer privacy

We believe customers have a right to high quality service that is safe, comfortable, and respectful. We developed our Customer Rights Charter to document our policies on customer rights, including customer service standards, compensation policies, grievance procedures, and privacy.

(3) Systems for environmental management

All our airport facilities have been certified under ISO14001 since 2005. We work hard to improve our environmental management every year, and are currently exploring the possibility of expanding our environmental management systems to cover all our offices and operations.

(4) Research and development on alternative fuels

We are participating in the Commercial Aviation Alternative Fuels Initiative (CAAFI), which was established to enhance energy security and environmental sustainability for aviation by exploring the potential use of alternative fuels. CAAFI provides a forum for the U.S. commercial aviation community to engage the emerging alternative fuels industry and to work together, share and collect needed data, and motivate and direct research on alternative fuels for aviation.

(5) Programs for customers with emergency travel needs

We offer bereavement fares and reduced fares to customers with special medical needs.

(6) Carbon management strategy

We have developed our Carbon Action Program to outline our short and long term strategy for reducing our carbon emissions. As part of the program, we have instituted the development of an annual greenhouse gas emissions inventory for all our Scope 1, Scope 2 and Scope 3 (business travel and commuting) emissions. The program outlines an 8 point strategy to achieve reduction of our carbon intensity by 10% over 10 years through a mix of operational optimization, lighting efficiency, teleconferencing and other strategies. We are active participants in the EPA's Climate Leaders and welcome the establishment of a national framework for regulating greenhouse gas emissions.

(7) Carbon offset programs for passengers

In October 2007 we launched our carbon offset program in partnership with Green Travel International. The program provides customers with an estimate of the greenhouse gas emissions associated with their travel plans, and enables them to purchase the equivalent

carbon offsets. Since launch of the program, over 16,000 customers have participated saving over 9000 metric tons of CO₂.

(8) Sustainable purchasing policies

Our sustainable purchasing policy was developed to handle our biggest non-fuel purchases, including catering service and paper. We serve only fair-trade coffee and source our snacks and meals from a catering facility that offers a mix of organic products. Our bottled water is purchased from local suppliers that give back to their communities. All our office paper is 100% recycled with a minimum 35% consumer waste, while our tickets are issued on paper that is 60% recycled.

(9) Commitment to sustainable operating practices

Greening-the-Sky Team was established in 2004 as an employee initiative to integrate sustainable practices into our office operations. The Team is active in raising awareness and promoting more sustainable ways of conducting our business. They have brought forth to management 17 “Green Beans”—ideas for growing greener practices within the organization-- of which 11 will receive over \$260,000 in initial funding. We are pleased to announce that last year a Greening-the-Ground Team was created to strengthen and promote environmental practices within our maintenance facilities.

**Figure E1 (page 3 of 3)
Example of Integrated
Reporting: Sustainability
Reporting as part of Form
10-K Report**

F

Appendix F
Policy Framework for Mandatory
Sustainability Reporting in the US

Appendix F

Any mandatory sustainability reporting framework in the United States will need to build on the current financial reporting system. Here we offer a brief overview of the financial reporting process in the US and then explore a few institutional models and policy options for integrating sustainability KPIs into the financial reporting process.

Financial Reporting in the US

Table F1 highlights the roles of key actors in the US financial reporting system.

The The Financial Accounting Standards Board and International Accounting Standards Board are the standard setters for preparation of financial statements. Efforts are underway to encourage their convergence to ensure one coordinated standard for how companies prepare financial accounts and present financial statements The Securities and Exchange Commission dictates to a large extent what information companies should disclose in the Form 10-K, which incorporates financial statements developed according to FASB. FINRA provides regulatory oversight of trading activities, while stock exchanges provide the platform on which trading occurs. Figure F1 illustrates the major steps in the financial reporting process.

| Name | Role | Institutional Model & Regulatory Authority | Instruments |
|--|---|--|---|
| International Accounting Standards Board (IASB) | Responsible for developing the International Financial Reporting Standards (IFRSs), and promoting the use and application of these standards. | Independent, privately-funded accounting standard-setter based in London, UK. The parent entity of the IASB is the International Accounting Standards Committee Foundation (IASCF). Standards developed by IASB are intended to be used globally for financial reporting, but are voluntarily adopted by national accounting bodies. | IFRSs are developed following an international consultation process, involving interested individuals and organizations from around the world and with the support of an external advisory council, the Standards Advisory Committee (SAC). The International Financial Reporting Interpretations Committee (IFRIC) develops guidance to promote consistent practice. |
| Financial Accounting Standards Board (FASB) | FASB's mission is to "develop, in the public interest, a single set of high quality, understandable and enforceable global accounting standards that require high quality, transparent and comparable information in financial statements and other financial reporting to help participants in the world's capital markets and other users make economic decisions." | Not for profit. Designated by the SEC as the organization responsible for setting accounting standards for public companies in the U.S. Note: FASB standards do not have the force of law. FASB is currently seeking to converge standards with IASB. | FASB develops broad accounting concepts and issues statements on accounting standards and concepts, interpretations and technical bulletins, which establish how corporations prepare financial accounts and statements. While FASB standards cover disclosure, it is the SEC standards that mandate disclosure requirements. |
| Securities & Exchange Commission (SEC) | The SEC's mission is to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. The SEC is empowered to require disclosure "as necessary or appropriate in the public interest or for the protection of investors" | Independent, non-partisan, quasi-judicial regulatory government agency. Administers and enforces 7 major laws that govern the securities industry (such as Sarbanes-Oxley Act of 2002). Enforces the federal securities laws and regulates the securities industry, the nation's stock and options exchanges, and other electronic securities markets. | SEC sets disclosure laws and regulations, all of which have statutory authority. SEC regulations impact GAAP and vice versa. The primary disclosure vehicles in the regular financial reporting cycle are the Form 10-K and 10-Q. Additional forms must be disclosed in certain circumstances (eg, Form 8-K, or company prospectus). |
| Financial Industry Regulatory Authority (FINRA) | FINRA promotes investor protection and market integrity through regulation, complementary compliance and technology-based services. It is responsible for regulatory oversight of all securities firms that do business with the public; professional training, testing and licensing of registered persons; arbitration and mediation; and market regulation by contract for exchanges (such as the American Stock Exchange and NASDAQ). | FINRA was created in July 2007 through the consolidation of NASD and the member regulation, enforcement and arbitration functions of the New York Stock Exchange. It is a self-regulatory organization (SRO), a type of entity created under the Securities Exchange Act of 1934. (SROs are organizations that exercise some degree of regulatory authority over an industry or profession). FINRA regulates trading in equities, corporate bonds, securities futures, and options, with authority over the activities of brokerage firms and registered securities representatives. | Licenses individuals and admits firms to the industry; writes rules to govern their behavior; examines them for regulatory compliance; and is sanctioned by the SEC to discipline registered representatives and member firms that fail to comply with federal securities laws and NASD's rules and regulations. |
| Stock Exchanges | Stock exchanges are private corporations established to provide a platform for trading stocks and securities between brokers and traders. They enable publicly-traded corporations to raise capital and undertake acquisitions, mergers and divestitures, while also serving as an information sources and a barometer of economic health. Exchanges have a key role to play in establishing listing requirements and rules to ensure a fair, healthy market for trading. However, surveillance, investigation and enforcement of insider trading is not conducted by the exchanges themselves but rather by organizations like FINRA or NYSE Regulation Inc. (a not-for-profit corporation). | Securities exchanges are required to register with the SEC and are subject to the regulatory oversight of the SEC. All rule and rule amendments proposed by exchanges must be approved by the SEC, who then seeks comments on proposed changes before they are finalized. Major exchanges in the US are publicly traded corporations. The New York Stock Exchange, for example, is owned by NYSE Euronext, a holding company created by the combination of NYSE Group, Inc. and Euronext N.V., while NASDAQ is owned and by the NASDAQ OMX Group. | The exchanges develop rules to regulate their member organizations and associated persons. The rules are designed to prevent fraudulent and/or manipulative acts and practices, promote just and equitable principles of trade, and establish the means for disciplinary actions. All rules and rule amendments proposed by NYSE must be submitted to the SEC Exchanges impose standards to ensure a minimum degree of quality among listed companies. These standards involve both financial and corporate governance criteria, however, compliance reviews are not public. |

Table F1 Roles and Responsibilities in the current US Financial Reporting System

Policy & Regulatory Approach

Establishing a mandatory system will require implementing new regulations and defining clear roles and responsibilities for institutions operating in this field.

There are many different models that can be pursued to achieve the objective of mandatory sustainability reporting. Key considerations in developing an appropriate model for the US include:

- **Role of Security Exchange Commission, stock exchanges, and accounting firms.** Ultimately it is the SEC that determines what information all publicly traded corporations must disclose, while stock exchanges set standards of size and financial viability necessary for listing. What should the relative roles of these two bodies be? How involved should they be in setting standards? Who else might take on this role?
- **Compliance costs.** Rigorous requirements, including requiring sustainability reporting to be completed at the same time as annual financial reports, could arouse opposition, possibly leading companies to list themselves on non-US exchanges, go private or incorporate offshore.
- **Business model.** How will the entity responsible for setting standards for sustainability reporting fund its activities, especially if standards must be created for a wide range of industries and through extensive stakeholder collaboration?
- **Ease of Implementation.** How difficult will it be to enact and implement the proposed system?
- **Verification.** What level of verification is needed and which body should carry this out?

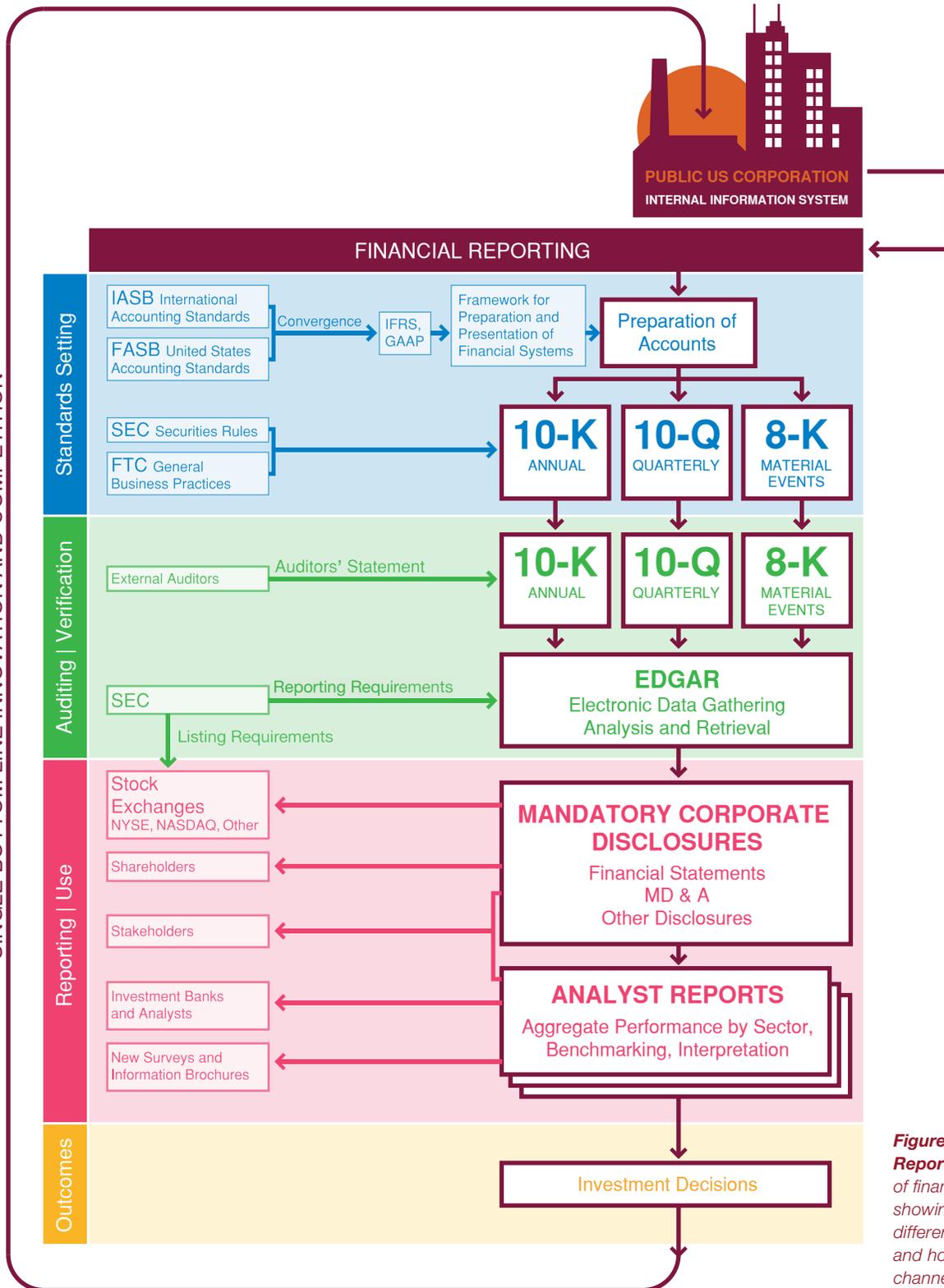


Figure F1 US Financial Reporting Cycle Illustration of financial reporting cycle showing participation of different stakeholders and how information is channelled to users

Identification and Evaluation of Different Models for Mandatory Sustainability Reporting

Table F2 shows three different approaches for creating a mandatory framework for sustainability reporting in the United States. Each would use different tools and would be driven by different actors. Key factors and risks for each option are considered.

A non-financial disclosure process will need to be integrated into current processes and new procedures and systems will need to be developed. Figure F2 provides an example of how non-financial reporting under Option 1 could be integrated into the current financial reporting process.

| | OPTION 1 New Accountability Disclosure Report or Section | OPTION 2 Enhanced MD&A | OPTION 3 Expanded Stock Exchange Listing Requirements |
|--|---|---|---|
| Brief Description | Companies would be required to prepare a an accountability report that covers ESG and other issues. A system that is similar or parallel to financial reporting under FASB would be established. | The MD&A disclosure requirements would be expanded or enhanced to require discussion of broader ESG issues. | Listing standards of stock exchanges would be modified to require reporting on ESG issue. |
| Key Instrument | Accountability report (new) or new section on 10-K | Expanded MD&A section on 10-k | Listing Standards (expanded) |
| Revised/ New Roles & Responsibilities under each Option | FASB: No change SASB: Similar to FASB, a Sustainability Accounting Standards Board (SASB) would be developed to establish principles and define guidance for reporting. SEC: Would have to make the accountability report a disclosure requirement that is part of or an addition to the 10-k. Audit: A new auditing/verification body may be needed, depending on the requirements established by SEC. | FASB: No change SEC: Would have to issue guidance or requirements for how companies should include discussion of ESG issues in MD&A. SEC could delegate this responsibility to SASB. Audit: No change as the MD&A is typically not audited. | Stock Exchanges: Would need to provide guidance/ requirements on disclosure in the Listed Company Manual. FASB: No change SEC: No change Audit: a new auditing/verification body may or may not be needed, depending on the requirements of the stock exchanges. |
| Process | A company prepares an accountability report based on the standards and guidance of SASB. The report may then be partially or entirely verified through an independent party. Through EDGAR or a similar system, the report contents would be uploaded for general distribution. | A company prepares its MD&A including additional information about ESG issues, as per SEC guidelines. As per existing procedures, the MD&A is included in the 10-K. | A company prepares disclosure information required as per listing standards (this could be a fuller accountability report or a more simple disclosure of information). The information may then be partially or entirely verified through an independent party. |
| Enactment Mechanism | Establish through government law (such as was the case for Sarbanes-Oxley). | Could be enacted by law or through SEC-led effort to change disclosure requirements. | As a voluntary initiative led by the stock exchanges, enactment would require SEC approval; alternatively regulation could be established by government law. |
| Key Considerations | <ul style="list-style-type: none"> -Enables dedicated institution to be established to promote and evolve sustainability reporting standards -Enables a more comprehensive, exhaustive approach in terms of determining what companies report on -Requires significant institutional changes and effort to establish an entirely new system with standards and guidelines -May lead to companies "going private" or registering themselves in other countries -Need to consider whether companies will be able to file the 10-k within required time period with these additional requirements | <ul style="list-style-type: none"> -Uses an existing instrument that companies are familiar with -Incremental approach that can be implemented with greater ease and can evolve over time -IASB has already decided against establishing industry specific indicators, preferring to focus on the approach to disclosure not the contents -Inclusion of detailed sustainability performance data and qualitative disclosures would be out of sync with the type/ depth of information currently presented in MD&A -Need to consider whether companies will be able to file the 10-k within required time period with these additional requirements | <ul style="list-style-type: none"> -Shifts responsibility for establishing disclosure requirements and standards to the private sector -May lead to creation of a less rigorous system -Represents a significant departure in the role of stock exchanges as they currently impose no public disclosure requirements -Potential conflict of interest as it is in the interest of exchanges to minimize regulatory burdens on companies -Likely to generate opposition from exchanges who see it as a competitive disadvantage and a significant burden imposed on them (and listed companies) -Would require wide adoption by exchanges to be effective -May lead to companies listing themselves on international exchanges instead |

Table F2 Options for different models to strengthen ESG Reporting

Management Disclosure & Analysis

As early as 2007, the IASB was studying the issue of how the management commentary (MC) section of a financial report (in the US called the Management Discussion & Analysis) could be expanded to provide further guidance on disclosure of non-financial issues. It has made the following conclusions:

- It is not appropriate to specify what information should be included in the MC. This should be at the discretion of management.
- Guidance should focus on setting the principles and qualitative characteristics to make the information useful for investors.
- Information in the MC's should be forward-looking, understandable, relevant, reliable (free from error), supportable (faithfully represents strategies, plans, etc.), fair and balanced, comparable and consistent (particularly over time more than between entities).

It should be noted that despite existing guidelines on what should be included in the MC (MD&A), there is still significant variation in how companies approach this section of the Form 10-K. For example, in the airlines sector Jet Blue's 2008 Form 10-K does not mention climate change and the potential risk this may pose, although information about its greenhouse gas emissions is found in its first environmental and social report. Meanwhile, American Airlines discloses in its 2008 Form 10-K that climate change regulation is a risk, but does not quantify the extent of this risk. Its environmental responsibility report does, however, disclose greenhouse gas emission levels.

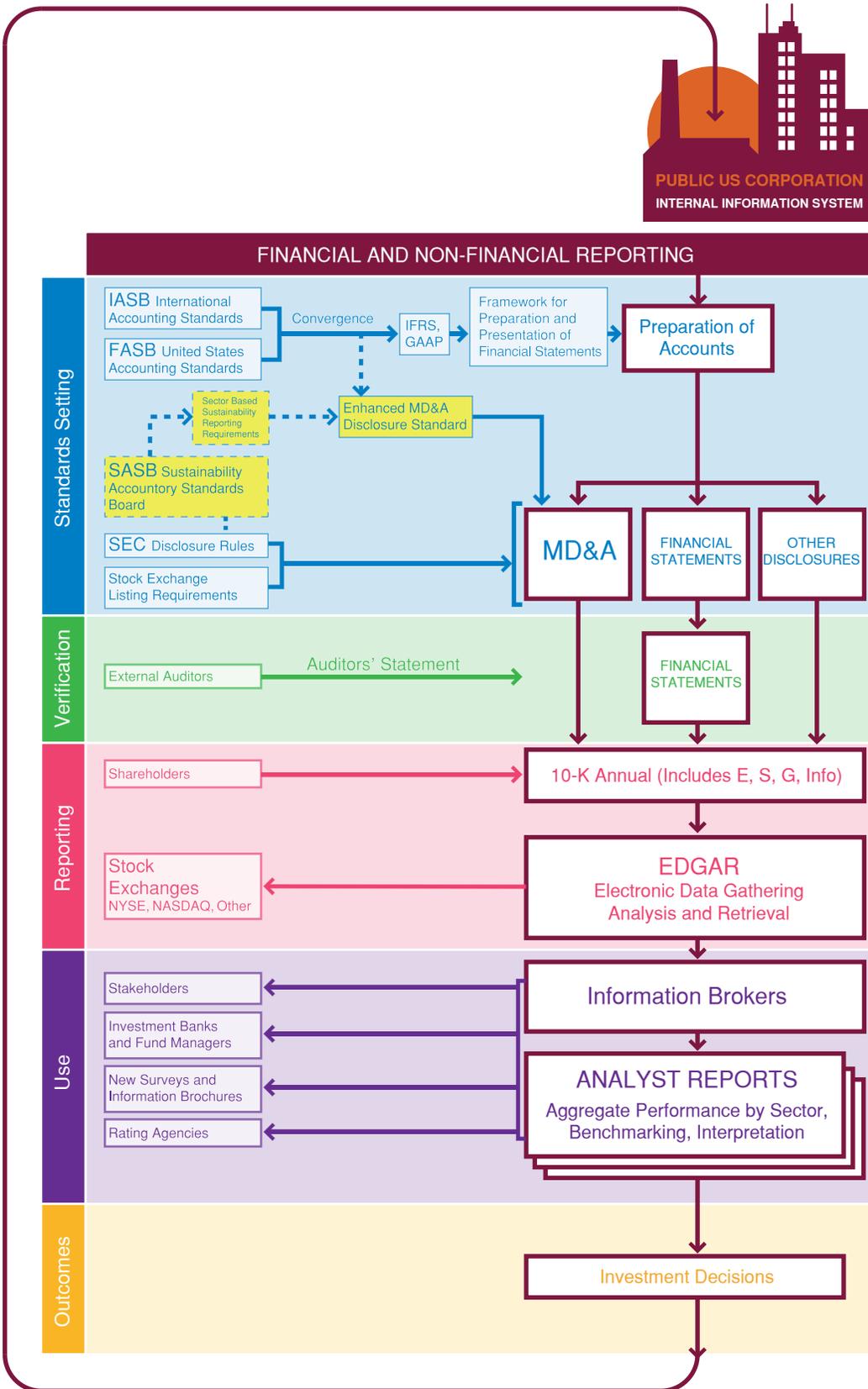


Figure F2 Example of Integrating ESG Reporting into Financial Reporting
 Illustration showing how sustainability reporting could be integrated into financial reporting cycle. The diagram shows key bodies that would need to be established to set standards. As with financial reporting, the data could be channelled to information brokers and analysts.

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About the IRI

The Initiative for Responsible Investment (IRI), a project at the Hauser Center for Non-Profit Organizations at the Harvard Kennedy School of Government, was founded to research and catalyze markets for responsible investment. The IRI focuses on responsible investment theory and practice across asset classes, and on the information that investors need to make informed choices that result in the generation of long term wealth for investors and society alike.

