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CARROLL SCHOOL OF MANAGEMENT

Center for Corporate Citizenship

Institute for
Responsible Investment

White Paper: Report on Project Findings

*The Use of Non-Financial Information:
What Do Investors Want?*

March 1, 2008

*A study of investor use of non-financial information made possible by a
generous grant by the FINRA Investor Education Foundation*

Authors

This pamphlet was written by Belinda Hoff and David Wood.

It is based on research conducted by Lori Holder-Webb, Jeffrey Cohen, Leda Nath, Belinda Hoff and David Wood as part of a broader study into non-financial information, supported by the FINRA Investor Education Foundation.

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Project Overview

Though advocates argue that nonfinancial information forms or should form an increasingly important part of investor decision-making, relatively little research has been done to analyze the nonfinancial information currently available or to determine how investors value specific types of nonfinancial information. This study has examined both the availability of specific types of nonfinancial data, as well as the extent to which retail and professional investors value nonfinancial information on key social, environmental, and governance factors.

We focused on three types of information – industry cohort, governance and corporate social responsibility (CSR) – each of which has received considerable attention from academics and advocates in recent years. We reviewed corporate disclosure practices of 50 companies across five industry sectors; we conducted surveys with embedded experiments of 750 retail investors and 228 professional investors; and finally, we gathered qualitative assessments from investors to supplement the survey and experimental data.

The goal of our research was to better assess both the supply and demand of nonfinancial reporting in the current investment climate. We believe that the results of this study offer academics, investors, corporations and regulators a clearer picture both of investor desires for nonfinancial information, and the ways in which various forms of reporting are used. The results can inform choices about which regulatory approach might be best applied to nonfinancial reporting. They can also support corporate and investor efforts to supplement that regime with voluntary corporate reporting on specific nonfinancial information types.

Project Background:

Experts have long observed the disparity between a company's total value as measured in stock price and the value of its underlying, tangible assets. To correct the information asymmetry that currently exists between managers and investors, some advocates have argued for reforms that better capture value drivers in the marketplace. According to these advocates, the current disclosure regime overemphasizes past results at the expense of future prospects and fails to provide valuable information that enables investors to assess long-term value.

Nonfinancial information may be a window through which light can be shed on key elements of corporate performance to help investors better determine how to allocate their money. Indeed, groups like the United Nations Environment Programme Finance Initiative (UNEP FI) have argued that, in a changing global business and regulatory climate, different types of information are now within the threshold of materiality in particular “nonfinancial” risk and opportunities. Perhaps the best known example of this in the United States is the emphasis on governance information heralded by the introduction of the Sarbanes-Oxley Act, a response to the much publicized corporate scandals of the late 1990s.

For all the emphasis on enhanced nonfinancial reporting, there remain serious obstacles to effecting new forms of corporate disclosure. Three obstacles in particular stand out:

- **Lack of data comparability:** Without adherence to consistent disclosure guidelines still absent despite the work of multistakeholder groups such as the Global Reporting Initiative, nonfinancial information can lack the comparability of traditional financial data.
- **Lack of data clarity and reliability:** Without clear regulations or effective auditing systems governing nonfinancial reporting, the credibility of voluntary corporate disclosures may be called into question.
- **Limited time and resources:** Investors have limited time and resources to analyze corporate data. Information overload – especially if that information has no clear link to investment decision-making – is a serious concern. Information ought to be accessible, easy to use and reliable for it to effectively support an efficient market.

This project is meant to better identify those types of information most desired by investors currently, and to identify whether and where there are areas where improvements in data comparability, clarity and reliability would facilitate investors' use of information they find material to their decision-making.

Project Design:

Our research focuses on the use of three categories of nonfinancial information:

Industry cohort measurements of performance linked to nonfinancial value indicators: Industry cohort measurements – information that contextualizes performance against peers – have received particular attention in modern management theory. It is argued that the real value drivers of a company – for example, worker productivity, corporate innovation and customer satisfaction – are often better assessed using industry cohort metrics. This approach may allow management to better identify the company's strengths and weaknesses. Similarly, these metrics would allow investors building portfolios to compare the relative performance of companies, enhancing opportunities to identify intangible value in their portfolio companies.

Corporate governance information

Corporate governance has become a key focus of investors and regulators in recent years. Director independence, audit processes and executive pay have become key drivers for assessing the robustness of a company's monitoring processes and its ability to prevent fraud and mismanagement – key indicators of portfolio risk for investors. The availability of corporate governance information may also help management and shareholders identify and improve on the systemic role that corporate governance plays in value creation.

CSR information on stakeholder relations, including work force, community and environment:

Advocates have recently focused on the business case for disclosing social information, stressing that many social and environmental issues present material risks for companies. Information on human rights policies, corporate environmental performance, corporate philanthropy, diversity policies, human resource development: these may all be important indicators of corporate value. Advocates of greater nonfinancial reporting often stress that poor management of these issues presents risks to corporate reputation or carries litigation risk. Others suggest that sound management of these issues can be a proxy for good management and an indicator of intangible value. By disclosing CSR Information, companies permit investors to assess these risks and opportunities, permitting greater insight into intangible value.

Project Phases:

To examine both the supply of, and demand for, such information, we conducted the study in three phases:

Phase One:

We examined the disclosure of nonfinancial information across a sample of 50 size- and industry-stratified public companies. Our research assessed the extent of current disclosure practices across 35 specific types of nonfinancial information, the quality of disclosure and size and industry differences.

Phase Two:

We conducted a survey and series of embedded experiments of 750 retail investors, along with a set of four focus groups, to determine retail investor use and preferred source for different types of nonfinancial data. Using the survey and focus group discussions, we examined the impact that extended nonfinancial reporting, audited nonfinancial reporting, including the relative effect of positive as opposed to negative information.

Phase Three:

We conducted a survey with embedded experiments of 228 professional investors to determine their past use, future interest in using and preferred source for specific types of nonfinancial information. The four experiments were used to determine the relative weight of extended reporting, the value attributed to auditing, and the value attributed to specific forms (i.e. website, 10-k) for reporting.

Summary of Findings:

Note: Here we present a brief summary of the findings from each phase of the project. For more complete accounts see the individual reports posted on the Web site of the Institute for Responsible Investment at www.bcccc.net/FINRAResearch.

Phase One: The Supply of Industry Cohort, Governance and Social Information in Current Disclosure Practice

In this phase of this study, a sample of documents produced by 50 size- and industry-stratified public companies was examined to determine what type of nonfinancial information exists in the current disclosure environment. The goal was to see to what extent, if any, demand for nonfinancial reporting had penetrated into the wider marketplace, and to see in a general sense if the information provided investors a platform from which to analyze investment decisions. We broke the three overarching categories of information (industry cohort, governance, and CSR information) into 35 subcategories, and then coded all publicly available corporate disclosures from the 50 companies to determine where, and to what extent, companies reported on each of these 35 types of information (see figure 1)

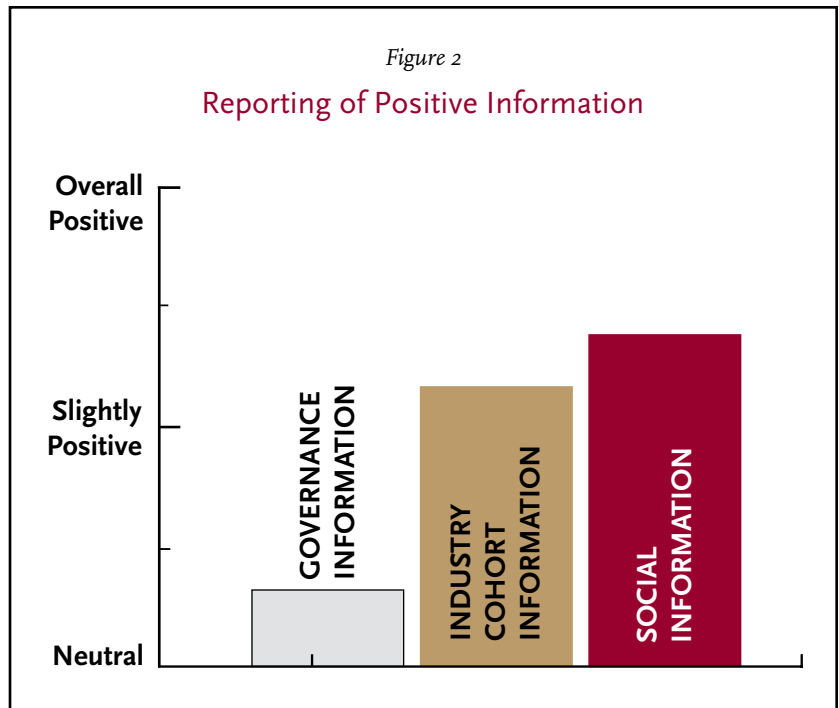
<i>Figure 1</i>		
Information Categories		
Industry Cohort	Governance	Social
<ul style="list-style-type: none"> • Market Share • Quality Rankings • Customer Satisfaction Survey Data • Employee Satisfaction Data • Turnover Data • Innovation Data • Other 	<ul style="list-style-type: none"> • Independence Standards • Board Selection Processes • Executive Compensation • Change of Control Procedures • Audit Processes • Ethics Guidelines • Management Systems • Adoption of Innovative Management Systems Balanced Scorecard/JIT/TQM • Other 	<ul style="list-style-type: none"> • Workforce Retention • Diversity Information • Employee Training/Human Capital Development • Health and Safety Record/ Industry Metrics • Supply Chain Practices • Human Rights Information • Humanitarian Initiatives • Customer Satisfaction or Product Safety Information • Community Relations • Political Giving/Lobbying/ Related • Environmental Ratings • Environmental Programs • Other

This research provides some preliminary conclusions. Certain types of non-financial information have clearly made it into the disclosure environment. Companies in research-intensive sectors see a reason to tell investors about their innovation strategies. Companies in the oil sector report on their environmental programs and all companies inform the market about their ethics guidelines and governance processes. The results show that companies currently are voluntarily reporting a range of non-financial information and that the intensity of such reporting is influenced by the company's size and industry sector.

Many companies release information on their on their Web sites and in press releases, while a few larger companies put out dedicated corporate social responsibility or corporate citizenship reports. Although these results highlight that industry sectors focus on areas of particular concern to them, they also show the type of information provided is not necessarily reliable across sectors and sizes of companies. In addition, there is a tendency to voluntarily report only positive information and the information that is provided is more often in unaudited formats. This potentially calls into question the veracity of the information provided and raises questions about the information that is absent (see figure 2).

The lack of metrics and common reporting frameworks means the information provided is not readily comparable across firms or industries. The research revealed a large instance of boilerplate reporting, particularly audit committee charters and independence standards. Boilerplate reporting offers little guidance to investors attempting to assess the strength of the company's monitoring processes and, more importantly, their appropriateness and effectiveness for the company's particular circumstances. Similarly, general claims in 10-Ks about corporate risk due to potential "changing market circumstances" may fulfill legal obligations, but they offer little insight for investors into the risk profile in the market. Management discussion and analysis sections, for instance, produce almost none of the information about risk and opportunity that governance and social reporting advocates claim is material to investor decision-making.

Nonfinancial information may offer investors valuable detail about the particularities about a corporation's industry cohort position, governance systems or social performance, but it does not yet provide the standardized assessment mechanisms associated with traditional financial reporting, which would permit rigorous analysis of the information presented.



Phase Two: Retail Investors' Use of Industry Cohort, Governance and Social Information

In this phase, we surveyed 750 retail investors to learn their attitudes toward the investment impact of industry cohort, governance and social information. Respondents did not think that nonfinancial information can supplant a focus on traditional financial analysis – far from it. But they did demonstrate a substantial interest in using nonfinancial information in conjunction with their financial analysis as part of their investment decision-making, despite the perceived limitations of reliability and comparability that nonfinancial information currently projects.

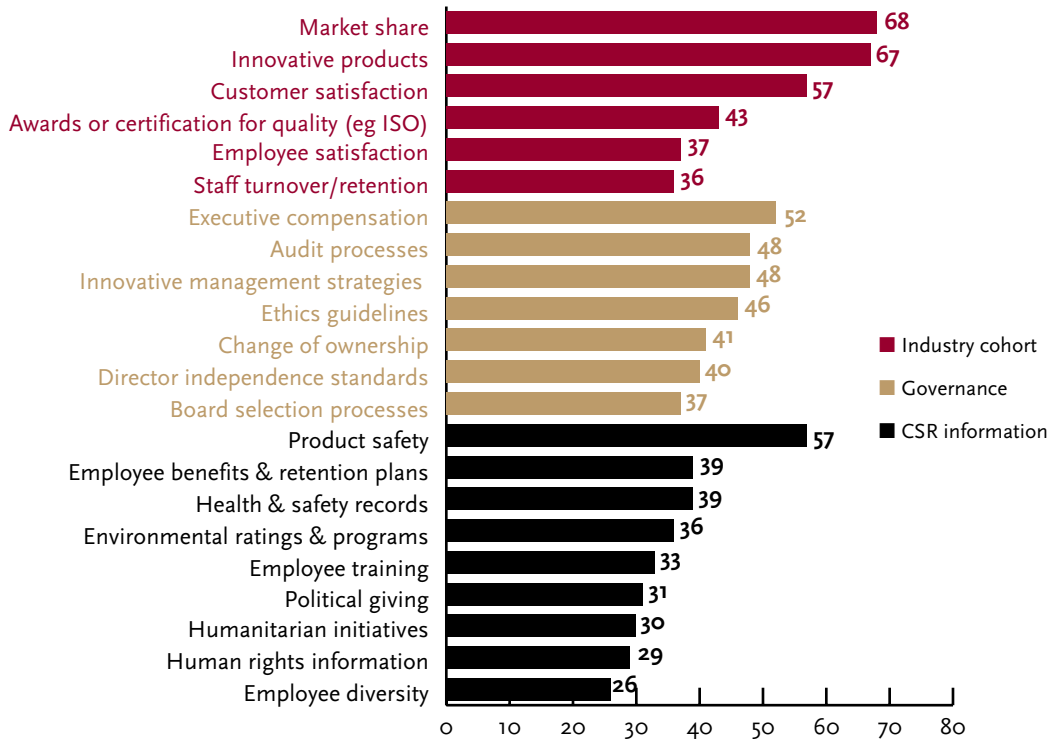
This study reveals a number of interesting findings about the way retail investors use nonfinancial information. According to our responses, it appears investors are already paying attention to nonfinancial information, particularly in categories related to industry cohort and governance, but also, notably, product safety. The results of the survey indicate that, of the three categories of nonfinancial information examined, respondents use industry cohort information the most (in particular, market share, innovation, and customer satisfaction), with 51 percent reporting having used it in the past. Forty-five percent of respondents reported using governance information, with the most popular type being executive compensation (used by 52 percent), perhaps unsurprising given the amount of attention paid to compensation in media business reporting in recent years. While only 36 percent of respondents reported using CSR information generally, the most frequently used subcategory was product safety information, cited by 57 percent of respondents, making it the fourth most referred-to subcategory of information (see figure 3).

Our survey also reveals some lessons about the presentation of nonfinancial information, which will be of interest to companies seeking to communicate their performance on industry cohort, governance and CSR issues. Respondents differed in their preferred source for these categories of information. For both industry cohort and CSR information, 33 percent of respondents preferred third-party sources and 31 percent preferred audited or regulated documents sources. For industry cohort information, 39 percent of respondents preferred third-party information, with the second-most preferred source being a financial professional (24 percent). For governance information, 43 percent of respondents preferred companies' audited annual reports or SEC filings as a source, with the second preference being third parties (24 percent).

Experimental results offered further insight into how retail investors approached different formats for and the reliability of nonfinancial reporting. The first experiment indicated that a higher level of detail positively influenced respondents' use of nonfinancial information. Where disclosure was more comprehensive, respondents were more likely to pay attention to the information. However, there appeared to be a limit to the impact additional information had on retail investor decision-making. Our second experiment revealed that the presentation of CSR information in audited or non-audited formats did not seem to matter to investors. Perhaps surprisingly, the experimental results suggested that multiple sources of information – in this case both the 10-K

Figure 3

Past use of nonfinancial information across categories



report and CSR report – negatively influenced their perception of the information. Having the information concentrated in one document resulted in greater attention from the investors.

From the discussion in the focus groups, it was clear there was a range of understanding about the auditing process and its benefits, with some participants noting that non-financial information is already “audited” – albeit informally – by third parties such as bloggers and others. Other participants seemed to support (and perhaps understand) the role of auditing better, and raised concerns about the ability of mainstream auditors to audit nonfinancial claims, particularly where this related to subjective information such as humanitarian initiatives.

Our survey of retail investors resonates with others tracking the use of non-financial information, indicating that there is growing awareness of the importance of non-financial information for investment decisions. Investor attitudes are likely to change over time, as certain types of information become more available and reliable, and more tools become available to provide quantitative assessments of the impact of non-financial performance on corporate performance or company value.

Phase Three: Financial Analyst and Investment Professional Use of Industry Cohort, Governance and Social Data

In this phase of the study, we conducted a survey of 228 professional investors from across the United States. An initial 149 respondents were drawn from a panel of professional investors, identified through the research firm Globescan. The remaining 79 respondents were referred to the survey through an e-mail notification sent by the New York Society of Securities Analysts (NYSSA) to its members. All respondents held at minimum a college degree and were asked screening questions to ensure they were involved in investment decision-making in a professional capacity whether through providing advice, conducting research or investing on behalf of their organization or a fund.

The results indicate that although there is still a relative lack of use of nonfinancial information in current decision-making, there is some desire to use the information more in the future (see figure 4). Professional investors paid more attention to industry cohort than to governance information, and paid the least attention to CSR information, of the three types of nonfinancial information presented in this study.

Interestingly, the main results from our experiments suggest that the primary attribute that influences professional investors' judgments is whether nonfinancial information is positive or negative in nature. There was significantly more emphasis placed on this information if it was positive than if it was negative. Surprisingly, neither the source of the information and the quantity nor the extent to which the information was assured appeared to influence the decision-making process.

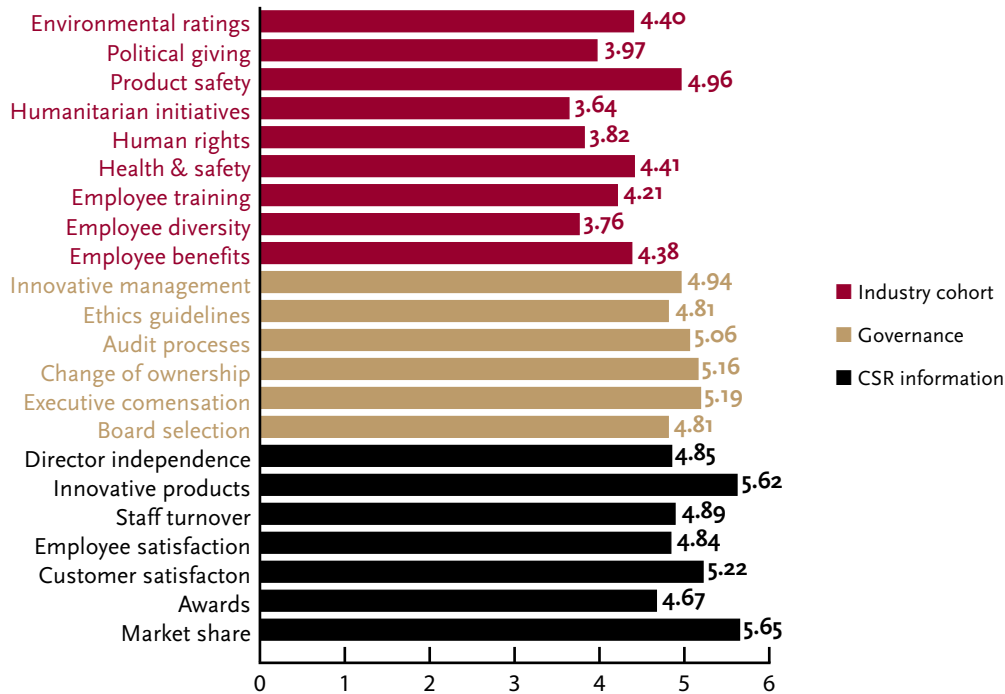
Professional investors preferred to get their information from either third-party sources or the company itself for industry cohort and CSR information, with the company's 10K being the preferred source for governance information. The preferred format in terms of reliability was the company's 10K or annual report, with the least reliable being the company's Web site. When asked to identify barriers to making better investment decisions, however, greater knowledge about environmental and community activities of the target company were ranked the lowest concern for respondents, with access to more comparable and streamlined information being their greatest concern.

There was some indication in the qualitative responses that third-party assurance is viewed favorably, as it was both noted positively where it existed and its absence referred to negatively, but these qualitative results did not match the quantitative experimental analysis. Even though information presented in audited form was viewed as more reliable, the level of assurance did not have any significant impact on the way respondents valued the company. Similarly, respondents indicated that companies need to better explain the significance of nonfinancial information to the bottom line if it is to be relevant to investors, suggesting that the non-financial data itself does not yet match investors' expectations for what decision-affecting data should look like.

Respondents with high percentages of SRI investments were significantly more likely to use nearly all types of nonfinancial information. Respondents who had taken a greater number of accounting courses were significantly more likely to use some types of nonfinancial information including corporate governance and CSR informa-

Figure 4

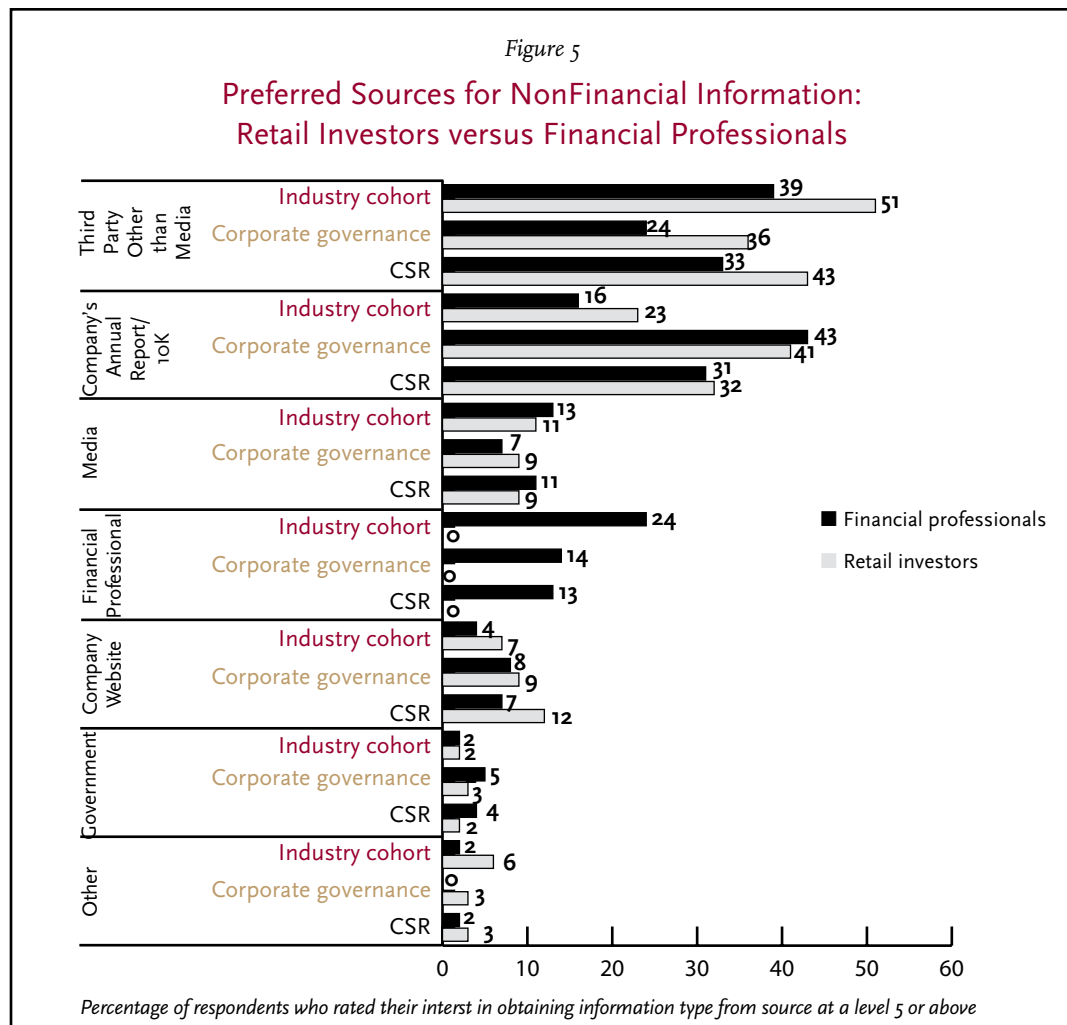
Future interest in using nonfinancial information



Respondents rated importance on a scale from 1-6.

tion. Finally, among the professional investors surveyed, financial analysts (both buy and sell side) are significantly less likely to have used or want to use almost all types of nonfinancial information.

This study thus supports the idea that professional investors include a variety of types of investment styles, with varying demands for and uses of nonfinancial information. This study therefore reveals a fruitful area for further research that would more fully reveal how educational background and investment style may affect the processing of investment information.



Retail Investors and Financial Professionals: Points of Comparison

One of the initial goals of this project was to compare the preferences for nonfinancial information held by retail investors and financial professionals. Advocates for enhanced disclosure have argued that professional training, and graduate school curriculum, may tend to inhibit the use of nonfinancial information by financial professional investors, especially financial analysts. On the other hand, retail investors, with less time and likely training to devote to their investment decisions, may be more likely to use nonfinancial information as a proxy for good governance and expected corporate performance.

Comparing the results of our surveys reveals that, on the whole, financial professionals and retail investors share a great deal in their evaluation of different kinds of non-financial information. As the adjacent chart reveals, retail investors and financial professionals overwhelmingly agree on their preferred sources for social, governance and industry cohort information (see figure 5). There is little evidence, for instance, to suggest that the retail investors rely substantially more on Web sites or public information than their professional counterparts.

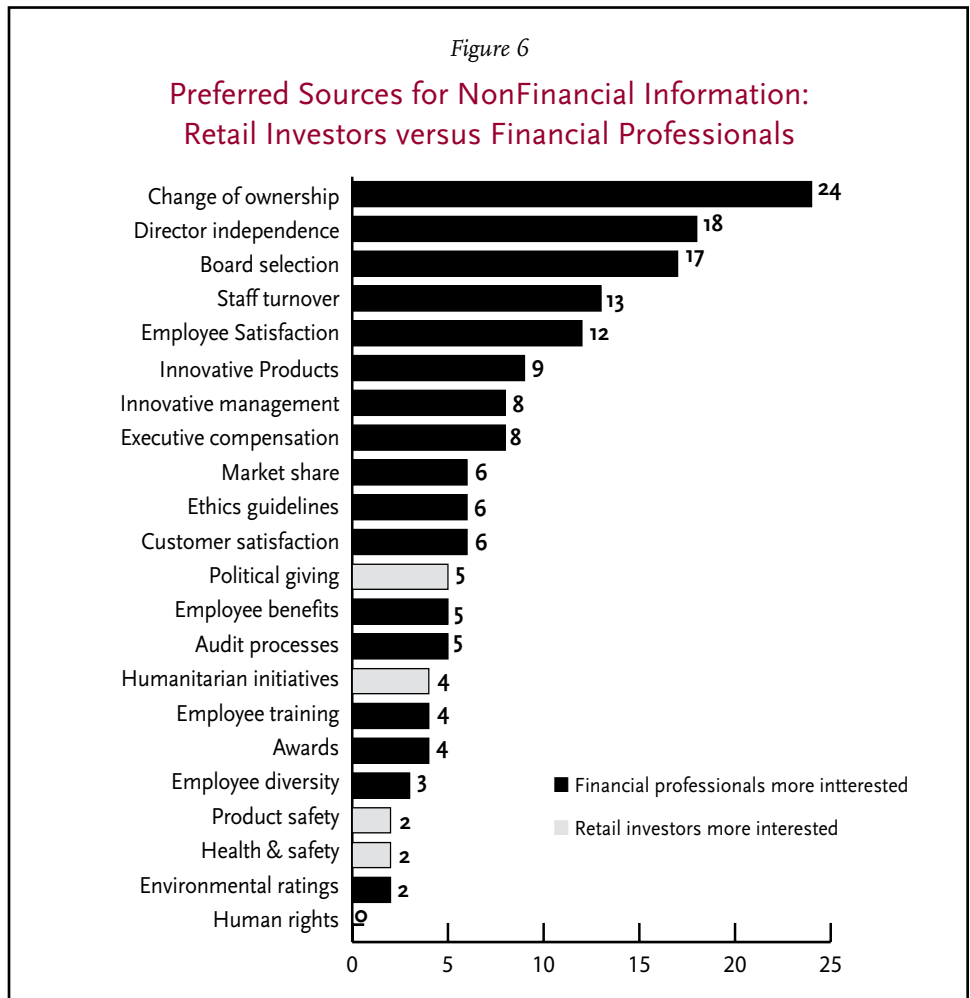
When asked to pick their top five most important kinds of information from a list of 22, both retail investors and financial professionals agreed on their top five choices, which were, in order:

- Market share;
- Customer satisfaction data
- Innovative products;
- Product safety;
- Executive compensation.

However, there were areas where professional investors and retail investors differed in their valuation of specific types of nonfinancial information (see figure 6). The adjacent chart reveals the differences between retail investors and financial professionals on specific types of information. In general, financial professionals tended to desire more information in nearly all categories, perhaps not surprising given their professional duties as information analysts.

A few categories do stand out, however.

Financial professionals generally desired more information on corporate governance and employee issues than retail investors. Of the few information types for which retail investors desired more information, the top two were humanitarian initiatives and political giving.



Overview of Conclusions

When viewed together, the three phases of this research offer a reasonably coherent picture of the state of supply and demand for industry cohort, governance and social information. In the first place, the supply of such information does exist, to varying degrees, in the universe of corporate disclosure. Different industry sectors emphasize different types of information; large corporations – perhaps because of their significant resources, perhaps because of their enhanced reputational risk – supply more information than their smaller counterparts; and corporations report on different types of nonfinancial information across the range of corporate disclosures, from Web sites and news releases to annual reports and 10-Ks.

The reporting itself, on the other hand, was not necessarily useful – that is, it did not provide data comparable across companies or industry sectors, or provided so little information as to offer the investor little to distinguish a particular company's performance across a range of nonfinancial metrics. And the nonfinancial information reported tended to be far more often positive than negative, suggesting it to be spin or at least partial in nature.

On the demand side – from the perspective of investors – we find a similar story. Both retail investors and professional investors acknowledge past use of nonfinancial information, and expect to use such information more in the future. While there are some differences, overall the retail and professional investment communities overlap a great deal in their rank ordering of the nonfinancial types of information examined in this study. Industry cohort information, especially market share and customer satisfaction, were seen as particularly important types of information. Governance information was seen as more useful than social information, with the notable exception of product safety as a key social indicator. Even for the least-used categories of social information, investors acknowledged a substantial level of interest. One notable result: financial analysts – that subset of professional investors – display the least interest of all respondents in all types of nonfinancial information, in most cases to a significant degree.

Nevertheless, investors tend to discount nonfinancial information to the extent that they find it incomparable, unreliable, or not directly material to corporate performance. Qualitative assessments from both retail and professional investors suggest that auditing and other forms of third-party verification increase the reliability of nonfinancial information. However, experiments revealed that both retail and professional investors did not substantially modify their decision-making when presented with audited or non-audited nonfinancial information.

Perhaps unsurprisingly, placing the results of supply and demand of nonfinancial information next to each other reveals something of a chicken and egg problem. Although interest from corporations in reporting this information clearly exists, it has not yet led to a fully fleshed system of data of use to investors. While investors are incorporating such information in their decision-making, and plan to do more in the future, they have not yet developed a systematic way to incorporate such nonfinancial information fully into their decision-making process. The qualitative responses to the surveys indi-

cate that where companies present information in a manner that effectively communicates its relevance to corporate value, investors are more likely to pay attention.

For advocates, regulators, corporations and investors, it seems that there is a space for a multistakeholder process that helps to coordinate standards for reporting information that is of use to investors. The Global Reporting Initiative – which has brought together a wide range of interested parties to support voluntary standards for corporate social reporting – is one model of how such a process might work. However, it should be noted that the skepticism investors have toward the reliability of (often voluntary) corporate reporting of nonfinancial information that tends to be overwhelmingly positive and not clearly linked to corporate performance, in combination with a corporate disclosure regulatory regime that neither mandates nor currently sets standards for nonfinancial reporting, may prove a significant barrier to greater use of this information.

Until these and similar problems are resolved, the research here suggests that a substantial unmet demand from investors for nonfinancial information will exist, regardless of how investor demands change over time



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The Center offers publications including a newsletter, research reports and white papers; executive education, including a certificate program; events that include an annual conference, roundtables and regional meetings; peer-to-peer learning forums and a corporate membership program.

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