International rating agencies and sustainability

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ABSTRACT

In the 1990s, the importance of international rating agencies became more pronounced among stakeholders who were interested in screening companies based on specific financial criteria. Now with a focus on sustainability, stakeholders are interested in screening companies on both financial and non-financial criteria. Specialised rating agencies have emerged developing new rating typologies to meet this need, and global stock markets have introduced indices to measure sustainability performance.

This paper provides a detailed examination of 17 major international rating agencies and their methodologies. Using an analytical framework underpinned by the audit independence literature, it finds that the majority of rating methodologies currently in use are unacceptable, and highlights the co-operative rating as the superior methodology.

The paper also provides a detailed examination of the nine global sustainability indices and their screening criteria. It finds that Australian organisations are not well represented.

And on the reporting front, the paper examines a number of extended reporting frameworks for sustainability disclosure, and finds that these have had little impact on Australia. With more Australian investors seeking responsible companies to invest in, and new legislation demanding sustainability disclosure, demand for extended reporting is increasing. Add to this the arrival of specialised rating agencies, and Australian companies may soon be forced to change their behaviour about sustainability disclosure.

SECTION 1: INTRODUCTION

In the 1990s, the importance of international rating agencies became more pronounced among investors, creditors, regulators and other stakeholders who were interested in screening companies based on specific financial criteria. In this period, rating agencies experienced growth and developed new ratings products (Cantor & Packer, 1996).

Section 1.1 will introduce the major rating agencies and the rating types and focus, before briefly highlighting a recent example of AMP and its reaction to ratings. Section 1.2 introduces the importance that ratings can play in corporate strategy, and explains how ratings can affect the behaviour of a corporation. Finally, the section will conclude with an outline of the objectives of the paper.

1.1 Rating agencies

Worldwide, there are numerous rating agencies providing financial ratings, however, the rating industry counts only two major world players both originating in the United States: Moody's Investor Services; and Standard & Poor's (S&P). They have become global following the dramatic growth of international financial markets and an increasing reliance upon credit ratings (Cantor & Packer, 1994).

The six major financial rating types and the focus of these ratings is shown below in Table 1.1:

Rating type	Focus of rating
Life Insurance	Solvency
Credit	Default Risk (corporation)
Mutual Fund	Performance
Sovereign	Default Risk (nation)
Corporate Governance	Performance
Sustainability	Performance

Table 1.1: Major financial rating types and their focus

A brief description of each of the six rating types is provided below:

Life insurance ratings rank the solvency of life insurance companies, and for stakeholders, such as policy holders and life insurance agents, provide a convenient reference point for comparing insurers.

Credit ratings are the most popular type of rating and rank the probability of default for a corporate issuer of debt, such as a private sector organisation or a public sector agency. Credit rating agencies are an integral part of modern capital markets and their ratings are used as benchmarks by regulators, lenders and investors.

Mutual fund ratings rank the probability of excess investment performance of investment funds within the same asset class. For investors and their advisers, mutual fund ratings offer a way to monitor the performance of individual fund managers and asset classes within the growing managed investments market.

Sovereign ratings rank the probability of risk of default of a sovereign country's obligation to repay its foreign debt. These ratings also set the maximum credit rating achievable for state and municipal agencies within that country's jurisdiction.

Corporate governance ratings rank the probity of information and decision-making systems within listed and multinational corporations. These ratings provide an assessment of an organisations performance based on the effectiveness of its command and control systems.

Sustainability ratings rank organisations effectiveness at meeting the expectations of stakeholders while maintaining sustainable financial, environmental and social performance. These ratings provide an assessment of an organisation's ability to deliver a sustainable future.

Currently, the ratings provided by international agencies, such as Standard & Poor's and Moody's, have become the default financial screening tools for rating risk and performance, and have become part of the essential lexicon of the corporate and investing community. Because achieving and maintaining a favourable rating for a corporation is so important, ratings are seen as a key influencer in corporate behaviour (Dillenburg, 2003). For example, the chief executive of the recently restructured insurance company AMP announced that before the company embarked on any major acquisition strategy, the company wanted to improve its standing with international rating agencies (Barnett, 2004, p. 28). To achieve this improvement in standing, AMP plans to use surplus cash to pay down debt over the next 12 to 18 months. Lowering debt levels will affect its credit rating and AMP wants to achieve a minimum of an "A" credit rating at a group level and a "AA" rating at an AMP Life level. It is predicted that this will lower its cost of capital and improve its image for shareholders.

Recently, part of AMP's corporate strategy was to achieve growth by acquisition. However, AMP is deferring the next step in rolling out its strategy until its debt levels are low enough to qualify for a higher credit rating and life rating (Barnett, 2004, p. 28). Part of the rating criteria used in these rating types is to factor into the rating a score based on debt levels (source: www.standardandpoors.com). The higher the debt levels, the lower rating.

In this example, the credit and insurance ratings are a key influencer in AMP's corporate behaviour (i.e. its decision to defer acquisitions and instead focus on debt reduction).

1.2 Importance of ratings

Organisations in the 21st century are surrounded by ratings. An insurance company manages its activities carefully to maintain or improve its A.M. Best rating, as that rating significantly impacts its ability to sell insurance products to the market. A corporation with debt is extremely interested in the Standard & Poor's or Moody's rating it receives, as that rating affects the company's cost of capital. An investment manager of a mutual fund company manages its investment products to obtain the highest Morningstar ratings possible, as it will capture increased market share of the investment fund flows (Dillenburg, Greene, & Erekson, 2003, p.172). Achieving a favourable rating is extremely important to companies because, ultimately, the ratings effect what products they can buy or sell, in what markets and at what prices (Cantor & Packer, 1995), which ultimately influences the profitability of the firm.

All of these examples are of common rating schemes that measure financial ratings of companies and have an impact in influencing corporate behaviour.

1.3 Objectives of this paper

There are two objectives to this paper. The first is to understand the development of international ratings agencies and rating types in a contemporary setting. The second is to explore the sustainability performance of organisations as determined by extended reporting frameworks and coverage by international rating agencies. In order to achieve this, the paper has seven main aims;

1. To explore the academic and other literature associated with the development and practices of international rating agencies.

2. To develop a framework to understand the various rating agency methodologies.

3. To examine these agencies in detail to determine the patterning of agencies among the various rating types.

4. To catalogue the methodologies used by the rating agencies.

5. To briefly explore the literature regarding sustainability and extended reporting frameworks.

6. To examine sustainability performance indices and determine the extent of Australian representation within these global indices.

7. To examine contemporary Australian situation concerning sustainability rating and reporting.

The above is achieved in part by focusing on the rating agency methodology and a detailed examination of the criteria for each rating type. A total of 17 rating agencies and 9 sustainability indices are examined in depth.

These objectives and aims are achieved in the paper via eight sections.

Section 1 generally provides an introduction into international rating agencies and their historical development. From this, it is determined that the majority of international rating agencies are concerned with the financial markets, especially credit ratings. Also it is established that international rating agencies can affect behaviour in various ways including performance disclosure, changing general strategies and financial strategies.

In section 2, the academic literature relating to this topic is examined across five main areas: (1) the types of rating products; (2) identifying possible changes in company behaviour, especially disclosure, because of international rating agencies; (3) the motivations for companies to increase disclosure; (4) the independence of rating agencies; and (5) the independence of auditors in their role of issuing an opinion on company disclosures.

Section 3 examines the issues associated with independence for a rating agency and the acceptability of their ratings by using the auditor independence framework. The three rating methodologies (solicited, unsolicited and co-operative) are also analysed to determine the acceptability of each method. This is done by examining the following: (1) the extent to which the rating agency is able to maintain independence; (2) avoid conflict of interests; and (3) obtain reliable information to make an informed rating opinion. It finds that the co-operative rating is the most acceptable rating methodology.

Section 4 empirically examines the major international rating agencies across each rating typology. The analysis focuses around six areas: (1) the scope and purpose of various rating typologies; (2) the background and context for each ratings typology; (3) identification of the major independent international rating agencies and their methodologies; (4) the revenue models used by these agencies; (5) identification of stakeholders; and (6) examination of issues affecting each rating typology. From this analysis, it was determined that a significant proportion of the rating products are solicited and therefore the independence of the rating agency is an issue. A major gap was identified in that there are few major rating agencies providing ratings on sustainability performance, however, as will be detailed below, there are a number of indices have been developed for this purpose.

Section 5 provides a definition of the wider view of the performance of an organisation and does this by briefly exploring corporate social responsibility (CSR) and sustainability[1]. These concepts are examined through the five major frameworks covered in the literature: (1) agency frameworks; (2) corporate social performance frameworks; (3) resource-based frameworks; (4) supply and demand frameworks; and (5) the stakeholder frameworks. Also, this examination identifies several motivations for an organisation to increase its stakeholder disclosure.

Section 6 identifies various reporting frameworks organisations can adopt to increase sustainability disclosure for their stakeholder. It finds that there is no generally accepted reporting framework for this area, and as such, is disjointed, even though both companies and stakeholders share a view for this increased disclosure and transparency.

Section 7 identifies and examines the various international sustainability indices that have recently emerged. In the absence of rating agencies providing extensive ranking of sustainability performance, these indices provide a useful screening tool for identifying large companies listed on global exchanges for the purpose of Socially Responsible Investment (SRI). The analysis of these indices focuses around their methodologies and their coverage of Australian listed companies. The findings of this

[1] The terms *corporate social responsibility* and *sustainability* have similar meanings, and are often used interchangeably to mean the same thing. Accordingly, the term ‘Sustainability’ is used throughout this paper as a catch-all phrase. Please refer to Section 5 of this paper for a comprehensive background on the development of the terms.

review are that there are very few Australian companies covered by the indices, even though there is a growing demand for SRI in Australia.

Finally, section 8 identifies contemporary developments in Australia and discusses the current Australian practices for extended reporting and disclosure, including: (a) the lack of an Australian SRI stock market index; (b) the extent of sustainability disclosure in Australia; and (c) the contextual factors affecting legislation that will influence Australian sustainability reporting. It finds that there are several factors that will increase the demand for extended reporting in Australia, and these will also increase the demand for sustainability ratings by independent rating agencies.

SECTION 2: BRIEF REVIEW OF PRIOR RESEARCH RELATING TO RATING AGENCIES

The aim of this section is to explore the academic and other literature associated with the development and practices of rating agencies. This section will briefly review prior research relating to rating agencies and examine auditor independence frameworks. Section 2.1 identifies that historically the major focus of the academic literature has been on rating types and their differences around the world. Section 2.2 will introduce a new research focus in the area of company behaviour and financial ratings. This will form a major focus for this paper, particularly the influence ratings have on corporate disclosure. Next, section 2.3 covers ratings agency independence. Finally, section 2.4 looks at the academic literature in the area of audit independence, and section 2.5 draws the similarities between an auditor's opinion and a rating agency opinion. This audit independence research will form the basis of the paper's rating agency independence methodology in section 3.

2.1 Focus of prior research

Historically, the majority of studies on rating agencies have tended to focus on the rating type, and how rating agencies rate firms differently around the world (e.g. Ferri, Lui & Stiglitz, 1999; Monfort & Mulder, 2000; Cantor & Packer, 1994 & 1996).

Recently, new research has emerged that has looked at the influence ratings have on corporate behaviour. This area of research, and the literature explaining the contemporary trends in company disclosures, will be examined in the next section.

2.2 Financial ratings and company behaviour

Dillenburg *et al*., (2003, p. 171) state that financial ratings can affect corporate behaviour to the extent that they are subject to ratings, over time, changing their management practices and their level and type of disclosure in an attempt to better satisfy the rating criteria.

Ratings, especially insurance and credit ratings such as solvency and risk, are extremely important to companies because ultimately the ratings affect what products they can buy or sell, in what markets and at what prices (Cantor & Packer, 1995). For example, the credit rating that a company receives will determine, which trading partners it will deal with, the cost of its capital and ultimately the profitability and market value of the company. It should be no surprise that companies modify their behaviour to suit a higher score in these types of ratings.

Another factor that is affecting the behaviours of companies is the level of disclosure and transparency it makes to its stakeholders. This ultimately affects how the company is perceived in terms of economic and social metrics. Social metrics are how the stakeholders view the corporation’s behaviour relative to acceptable standards regarding environmental, ethical and social performance. This is often referred to as *sustainability.*

Also, there has been a considerable amount of research undertaken into the correlation between the financial performance of a company and its disclosure regarding its CSR practices and the transparency of its corporate governance. While the conclusions of this research remain contested between business and academia, there is a growing body of credible evidence to suggest that there is a link between increased financial performance and increased levels of CSR disclosure and transparency (Bauer *et al*., 2003, Gompers *et al*., 2003, Romona, *et al*., 1999, Harrison & Freeman, 1999).

It is not just academics who are highlighting the link between disclosure and performance, but investors' too. McKinsey's (2000) *Investor Opinion Survey on Corporate Governance* identified that three-quarters of investors believe that board practices are at least as important as financial performance when evaluating companies for investment. This McKinsey survey highlights that the majority of investors place Socially Responsible Investing (SRI) on par with or ahead of the financial performance of their investments.

With the changes in attitudes towards transparency and disclosure, especially from investors, and a greater appetite for socially responsible investing (Greene, 2003), companies are becoming more interested in these social metrics.

SRI in Australia continued to grow rising to at least $21.3 billion in funds under management by 30 June 2003, an increase of 54% from 2002. The number of SRI managed funds has also increased substantially. In 1996, there were 10 SRI managed funds and in 2003, this had grown to 63 managed funds (Greene, 2003).

In meeting this growing demand in SRI investment, new specialised products have been developed to track the performance of this new investment style. One of these is the Dow Jones Sustainability Index (DJSI), which has consistently outperformed the

Dow Jones Industrial World index (DJGI). For example, the total return on the index for the period December 1993 to February 2004 is 153% for DJSI and 108% for DGJI (source: www.sustainability-index.com). This is often cited as evidence that there is a link between increased financial performance of a firm and corporate social responsibility (Bauer *et al*, 2003; Brown & Caylor, 2004, Grompers *et al*., 2003; Hamid & Sandford, 2002; Harrison & Freeman, 1999; Pava & Krausz, 1996; Roman *et al*., 1999; Waddock & Groves, 1997).

Internationally companies are changing their behaviour and using disclosure and transparency as a strategy for gaining competitive advantage (Geld & Strawser, 2001; Fowler, 2002; Uren, 2003, Wilson, 2004). These companies are using their disclosure and reporting practices to differentiate their products and services, gain access to new markets, reduce their cost of capital, improve their stock prices and their financial performance.

This change in corporate behaviour and reporting practices has been bought about by new economic and social disclosure frameworks, which focus around the voluntary disclosure of information by a company (Geld & Strawser, 2001). Frameworks such as Triple Bottom Line (TBL) and the Global Reporting Initiative (GRI) provide a means for a company to voluntarily disclose information to its stakeholders on a range of economic, environmental and social metrics. Another catalyst for a change in corporate behaviour is the introduction of financial rating agencies specialising in measuring a company’s performance against a range of social metrics.

Increasing stakeholder preferences for responsible and sustainable corporate behaviour (Greene, 2003) has spearheaded a new investment style, called Socially Responsible Investment (SRI), where investment is directed to those corporations who not only satisfy certain financial criteria, but also operate a business on a reliable, sustainable and desirable basis that respects ethical values, people, communities and the environment. SRI is slowly unfolding from a self-referential paradigm of screening to a comprehensive paradigm of seeking to modify corporate behaviour.

2.3 Independence in rating agencies

Another area in the literature that has received some attention has been the area of independence and rating methodologies. Rating methodologies can be classified as either paid (*solicited*) or unpaid (*unsolicited* or *co-operative*). The issue of a payment to rating agency may: (1) create a conflict of interest between the rated company and the rater; and (2) provide a less accurate rating.

Because the rating agency receives a payment from the rated company when a solicited rating methodology is used, there exists the possibility of a conflict of interest. This conflict of interest can create an upward bias in the rating result, hence providing a less accurate rating (Cantor & Packer, 1997; Winnie, 2003). This accuracy issue is not present in unsolicited or co-operative ratings.

Maintaining independence for a ratings agency is important as this will influence the acceptability of the rater's opinion in relation to a company's disclosures. Another area in the academic literature where the independence and acceptability of an opinion regarding company disclosures is vitally important is the area of audit independence. This area will be examined in the next section.

2.4 The importance of auditor independence

The auditing of financial statements is an essential part of the framework, which supports capital markets and other activities. The auditor's opinion adds value to the financial statement disclosures provided by a company through the independent verification it provides (Johnstone, Sutton & Warfield, 2001). If the auditor is not seen to act independently of the company, then the audit opinion loses its value to the stakeholders. They argue that auditor independence is fundamental to public confidence in the audit process and the acceptability by stakeholders of auditors' reports.

The collapse of Enron and the demise of Andersen have generally undermined confidence in the world's capital markets. Concern has focused on accounting and auditing practices, and particularly on the independence of auditors (Pound, Gay, Simnett, 2002).

A significant and persistent criticism of auditors through the academic literature is that the provision by auditors of non-audit advisory services to companies undermines the independence of the audit. Four issues relating to the independence of the auditor have been identified (see, Antle, 1984; ICAEW, 2000; Shockley, 1981; Pringle & Bushman, 1996). These four issues are: (1) the remuneration model of the audit firm; (2) the level of non-audit advisory services provided by the auditor to the company;

(3) the procedures for issuing and varying an audit opinion; and (4) the existence of conflicts of interest between the two parties

These audit independence issues are managed through both ethical codes of conduct and legislation. In Australia, for example, the CLERP 9 audit reform proposals are a legislative move designed to improve auditor independence. These reforms include a disclosure by the company in the annual report of non-audit advisory income, and a mandatory statement issued by the audit committee stating that they are satisfied that the provision of non-audit advisory services is compatible with auditor independence.

2.5 Similarity between auditors and rating agencies

There are several similarities between the roles of auditors and financial rating agencies. Both issue opinions based on company disclosures; both are fundamental to the operation of financial markets; both have the capacity to affect the behaviour of a company; and both need to maintain independence to ensure acceptability of their opinions.

It is for these reasons that this paper will, in section 3, analyse the issues of independence in rating agencies from the framework of audit independence.

SECTION 3: INDEPENDENCE IN RATING AGENCIES

The aim of this section to develop a framework to understand the various rating agency methodologies. This is achieved by focusing on the issues affecting the independence of rating agencies. Section 3.2 examines rating agency independence using an audit independence framework. Section 3.3 provides an example of a rating agency that is not independent. Section 3.4 analysis the three rating methodologies *solicited*, *unsolicited* and *co-operative* and compares their independence and acceptability, and section 3.5, summarises the acceptability of the rating methodologies.

3.1 Focus on independence

Maintaining *independence* for a rating agency is essential in protecting its credibility and ensuring that the objectivity of its judgment is not impaired because of its remuneration model, corporate relationships, conflicts of interest or ownership.

Because a rated company may pay a fee to the rater, this does not in itself create an *actual* conflict of interest, (i.e., a conflict that impairs the objectivity of the rater's judgment and is reflected in their rating). Rather, it is more appropriate to classify it as a *potential* conflict of interest, (i.e., something that should be disclosed and managed to ensure that it does not become an actual conflict).

The revenue model common among many rating agencies comes from two principal sources: (a) the sale of subscriptions to their research; and (b) fees paid by companies for the solicited ratings. This revenue model is analogous to members of the media that derive revenue from: (a) subscribers; and (b) advertisers that include companies covered in their publications.

Take for example the issue of independence and conflict of interest in a media company that derives revenue from its subscribers and advertisers that include companies they cover. For a media company, maintaining independent, unbiased coverage of the companies they cover is important to subscribers and the marketplace in general.

Making opinions about the acceptability of financial statement disclosures is the role of the auditor, and audit independence is an area that has revived attention in the academic literature. For this reason the audit independence framework will be used to identify issues of independence in rating agencies.

3.2 Issues associated with independence for rating agencies

In determining if a ratings agency is independent of the company that it rates, four factors from the audit independence framework should be considered: (1) the remuneration model of the ratings agency; (2) the level of advisory services provided by the agency to the company; (3) the internal procedures of the ratings agency for issuing and varying a rating; and (4) the existence of conflicts of interest between the two parties.

3.2.1 Remuneration model of the rating agency

Many independent rating agencies manage potential conflict through their remuneration policies. For example, the revenue received by a ratings agency from a company that is rated by their analyst is not a factor in that analyst's compensation. Instead, an analyst's compensation is a function of performance metrics, such as the quality and timeliness of research.

3.2.2 Level of advisory services provided by the agency to the company

Rating agencies are seen as being independent where they do not have an advisory relationship with the companies they rate. This is similar to one of the principal requirements to protect the independence of auditor firms and their audit clients. This exclusion of an advisory relationship is a means by which the rating agency always maintains full independence and its revenue model is not based on the success of, or tied to, the level of the rating issued, and the level of fee charged to a company is not dependent on the ratings assigned.

3.2.3 Procedures for issuing and varying a rating

Rating agencies maintain an independence from their clients where there are clear procedures for varying the rating where the circumstances of the rated company change. This ensures that the rating agency is at complete liberty to issue a different rating if circumstances change between, say, the issuance of the conditional rating and the final rating.

3.2.4 Existence of conflicts of interest

Conflicts of interest can arise from the remuneration model used by the rating agency (Cantor & Packer, 1997; Winnie, 2003), but they can also arise from the ownership structure. For example, the rating agency is owned or controlled by the company being rated. Rating agencies are seen as independent where there is no conflict of interest because of their ownership.

In exploring the question of independence in rating agencies, section 3.3 will briefly highlight some of the issues for one Australian rating agency, OzTam.

3.3 Example of non-independent rating agency in Australia

In Australia, for example, OzTam is the sole rating agency that publishes metropolitan free-to-air television ratings across the nation. These ratings are directly correlated to the level of advertising investment made nationally in television (as opposed to other media such as radio, newspaper, cable television, etc.). The OzTam ratings will therefore have a direct impact on the revenues and profitability of the metropolitan free-to-air television networks. OzTam was recently established as a joint venture between the three commercial television networks (Channels Seven, Nine and Ten) that operate in Australia. Through an exclusivity licence granted by these television networks, OzTam is the only ratings agency authorised to publish these ratings. Due to this obvious conflict of interest between OzTam and its ratings clients, OzTam would not be considered an independent rating agency.

The next section will focus on the independence of rating agencies by using the framework developed in the audit independence literature to analyse their methodologies.

3.4 The distinction between rating methodologies

Rating issued by a rating agency can generally be classified as either a *solicited, unsolicited* or *co-operative*. This classification is used to distinguish the rating methodology upon three key attributes: (1) whether the company being rated has requested the rating; (2) whether the company being rated has paid the agency for the rating; and (3) whether the information source used by the rating agency relies on confidential and non-public information. The *co-operative* rating is a form of unsolicited rating where the rated organisation co-operates with the rating agency to provide additional sources of non-public information. This co-operation by the company to provide additional information helps to improve the reliability of the rating and therefore its acceptability to users.

3.4.1 Requested ratings

Solicited ratings differ from unsolicited ratings in that the company seeking a rating requests the services of an agency to review its operations and issue a rating. An unrequested or unsolicited rating is where the rating agency issues a rating for a company, regardless of whether the company has requested the service or not. The co-operative rating is a form of unrequested or unsolicited rating.

3.4.2 Paid ratings

The compensation structure, hence agency framework, for unsolicited ratings differs markedly from solicited ratings in that the rating agency is not compensated by the firm for an unsolicited rating, whereas solicited ratings are almost entirely paid for by the rated organisation. As a co-operative rating is a form of unsolicited rating, the rating agency is not compensated for performing the rating service.

3.4.3 Information source

The information source, hence rating methodologies, for unsolicited ratings differs markedly from solicited ratings in that an unsolicited rating is purely a statistical rating based on publicly available information published by the rated company (see Figure 3.1 below). With a co-operative rating, the rating agency relies on publicly available information as its primary source, plus supplementary information that may include surveys, interviews and other types of specifically requested non-public data.

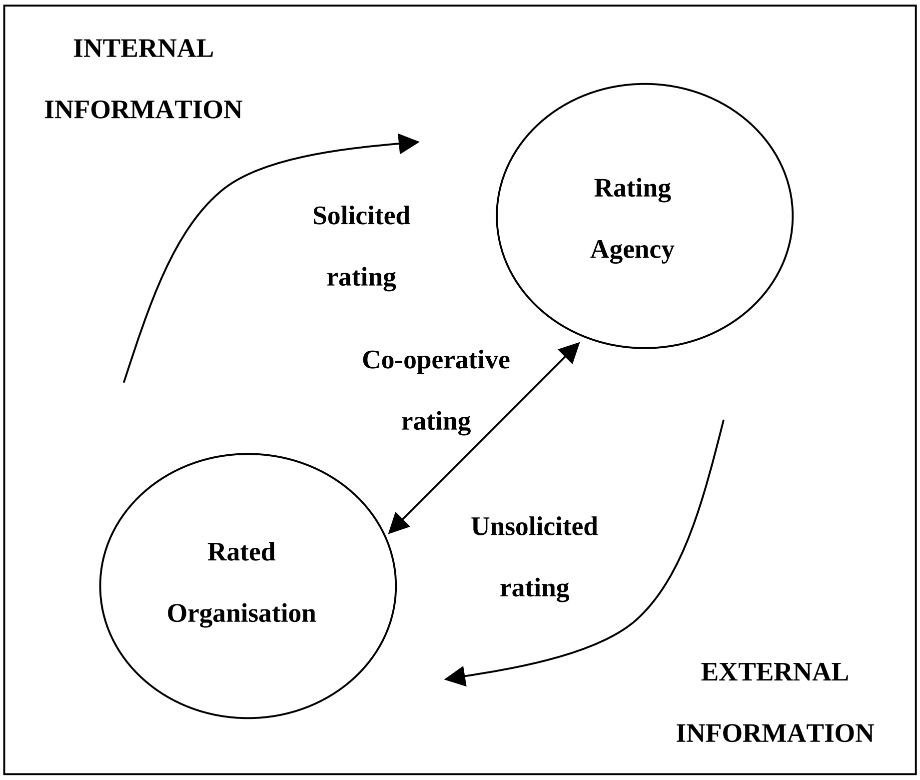

Figure 3.1: Information sources for solicited, unsolicited and co-operative ratings

3.4.4 Comparison of independence

A comparison of the independence of rating methodologies is provided in Table 3.1 below.

	Solicited	Unsolicited	Co-operative
Requested by rated company	Yes	No	No
Payment to rating agency	Yes	No	No
Information source	Company confidential information	Public domain only	Public domain and company confidential
Maintained independence	No	Yes	Yes

Table 3.1: Comparison of the independence of rating methodologies

Comparing the three different rating methodologies, it can be concluded that under the solicited rating method the rating agency has: (1) a more reliable information source to form an opinion however, (2) it is unable to maintain its independence because of the existence of conflicts of interest, particularly in relation to the terms of its engagement and the payment it receives. These issues of independence are not typical under an unsolicited or co-operative rating methodology. Issues such as these will affect the acceptability of the rating method.

3.5 Acceptability of different rating methodologies

The acceptability of the rating is ultimately the measure of it success, and this will be influenced by two key factors. The first issue affecting the acceptability of the rating methodology is maintaining independence and avoiding conflicts of interest. This issue has already been examined above section 3. The second issue that influences the acceptability of the rating methodology is the range of relevant information that is relied upon in forming the rating opinion.

Different rating methodologies rely on different information sources to determine the rating (see Table 3.2 below), and this source of information will ultimately determine the acceptability of the rating. Unsolicited ratings rely entirely on information in the public domain and, as such, the ability of the rating agency to issue an accurate rating is determined by the range of relevant information and the timeliness of the information that has been publicly disclosed by the company. Where a company does not disclose information into the public domain that is required by the rater's rating criteria, it is probable that any rating opinion that may be issued has not formed using all relevant information. This absence of information creates an acceptability issue for stakeholders relying on the rating. This acceptability issue is not present in solicited or co-operative ratings.

A summary of the acceptability of the rating methodologies is shown in Table 3.2 below.

	Solicited	Unsolicited	Co-operative
Conflict of interest	Yes	No	No
Range of information	Yes	No	Yes
Acceptable methodology	No	No	Yes

Table 3.2: Comparison of acceptability of different rating methodologies

In summary, the co-operative rating type can be seen as being a more acceptable methodology because this method avoids any potential conflict of interest while maintaining a high degree of reliability in the information source.

3.6 Conclusions regarding independence and methodologies

Rating agencies methodologies are classified as *solicited*, *unsolicited* or *co-operative* depending upon: (1) whether the rating has been requested; (2) whether the rating agency receives a payment; and (3) what information source the agency uses to form its opinion. These different methodologies will affect the level of independence the agency has in forming an unbiased and objective opinion, and ultimately this will affect the acceptability of the rating. The unsolicited and co-operative rating methods allow for independence to be maintained because independence is largely driven by agency remuneration. Ultimately, the most acceptable rating methodology is the co-operative rating method because of the greater reliability of the information source that is used n forming the rating opinion.

The next section will examine the ratings typologies identifying the international rating agencies, their products and their methodologies. This section will form the basis of the empirical analysis in this paper.

SECTION 4: ANALYSIS OF RATING TYPES

The aim of this section is to examine these agencies in detail to determine the patterning of agencies among the various rating types and to catalogue the methodologies used by the rating agencies.

The focus of the following sub-sections (4.1 to 4.6 inclusive) is to examine financial ratings by the type. There are six financial rating typologies (Table 1.1) comprising: life insurance; credit; mutual fund; sovereign; corporate governance; and sustainability.

An analytical framework was developed using insights from the literature reviewed in Section 2 and Section 3. This analytical framework has six elements: (1) scope and purpose; (2) background and context; (3) major international agencies and methodologies; (4) revenue models; (5) stakeholders; and (6) issues affecting the rating typology.

In section 4.7, the paper will conclude with some general observations about the major international rating agencies operating across each of the six typologies.

4.1 Life insurance (solvency) ratings

Solvency is a measure of a company's ability to meet maturing obligations as they become due. A company is deemed to be solvent where it has sufficient assets (capital, surplus, reserves) to be able to transact business and meet liabilities. Within the life insurance industry, solvency is used as the key indicator for determining the financial health of one life insurance company relative to another. Thus the life insurance industry comparison is generally made by the use of solvency ratings, also known as life insurance ratings.

4.1.1 Life insurance ratings - scope and purpose

A great deal of focus is placed on the life insurance ratings by their stakeholders as a way of independently ranking the solvency and financial health of one insurer against another. These ratings provide a convenient reference point for comparing insurers. They also provide some level of consumer protection in distinguishing between the insurers based on disclosed solvency, and are useful for regulators to benchmark the financial health of the insures they govern relative to international best practice.

4.1.2 Life insurance ratings - background and context

With many major economies experiencing recessions and continued uncertainty in global markets, conditions for life insurers have become increasingly difficult. The profitability of many insurers has been greatly affected by world events, such as the catastrophic drop in Asian real estate prices, the continued weakness in Japanese equity markets and, to a lesser extent, US equity markets, a decline in premium payments and the outright cancellation of policies, and historically low interest rates, coupled with the guaranteed high rates that life insurers are obligated to pay.

The continued failure of insurance companies has highlighted insurer solvency to be the number one issue affecting consumers of life insurance products. Weiss Ratings Inc. reported that in the United States alone, 40 insurance companies failed in 2001, losing in excess of US$4.2 billion of policyholders assets; and 38 failed in 2000, losing in excess of US$1.1 billion of policyholder assets (Weiss, 2001).

In Japan, for example, the failure of Kyoei Life Insurance, the nation's 11th largest life insurer, which ran into trouble in 2000, owed total debts of US$42.4 billion and became the biggest corporate bankruptcy in Japanese history (Earnshaw, 1993).

In Australia, the collapse of HIH, Australia's second largest insurer, prompted the Government to establish Australia's first Royal Commission in seven years to fully investigate the causes that led HIH to seek the appointment of a provisional liquidator in March 2000. KPMG, who was administering the company, estimated that the total liabilities of HIH could exceed AUD$5.3 billion (Westfield, 2003).

It is not just the outright collapse of life insurance companies that has captured the attention of stakeholders. Increasingly, life insurance policies are failing to meet the projections forecast in the sales illustrations because of falling interest rates and reduced dividends. In this environment, solvency ratings have become the focus for examining a life insurance company (Earnshaw, 1993, p. 48).

Solvency ratings help to alleviate imperfections in insurance markets by providing stakeholders with an opinion on an insurer's financial strength, including its operational performance and its ability to meet its obligations to policyholders (Bouzouita and Young, 1998, p. 23).

4.1.3 Life insurance ratings – major agencies and methodologies

Rating methodologies vary between rating issuers, but, generally, the ratings are designed to judge the financial health of the insurance company, using qualitative methods, such as quality of earnings, adequacy of provisions and spread of investments. They also provide a quantitative method to compare the strength of one life insurer against another. This is achieved by the rater issuing its own letter rating to each rated life insurance company based on their proprietary ratings distribution.

Solvency ratings are issued by the following independent rating agencies:

- A.M. Best Company
- Duff & Phelps
- Moody's Investors Service
- Standard & Poor's
- Weiss Ratings

A.M. Best Company and Weiss Ratings are the largest international rating agencies. They base all their ratings on a combination of publicly available financial data and inside information provided during formal company visits. In the case of A.M. Best, the financial tests measure corporate financial performance in terms of profitability, liquidity and capital structure, while the qualitative analysis includes an evaluation of an insurer's spread of risk, managerial expertise, and adequacy of systems of internal control (Pottier, 1997).

4.1.4 Life insurance ratings – revenue models

Of the largest rating agencies, A.M. Best and Weiss provide solicited and unsolicited ratings on almost all life insurance companies, while Duff & Phelps, Moody's Investor Services and Standard & Poor's provide solicited ratings only for those life insurance companies that contract with them and pay a fee for a rating (Earnshaw, 1993, p. 49). None of the major rating agencies provide co-operative ratings.

4.1.5 Life insurance ratings – stakeholders

The major stakeholders affected by life insurance ratings include life insurance companies, policyholders who are the consumers of their products, life insurance agents and investment advisers who promote life insurance products, life insurance regulators and governments.

4.1.6 Life insurance ratings – issues affecting these ratings

The two major issues affecting solvency ratings are: (1) there is no uniformity of the ratings scale; and (2) given the lack of uniformity, a comparison of ratings between agencies is therefore meaningless.

Despite each ratings service issuing either a scholastic type "A-F" scale for each life insurance company it rates, the first issue affecting the solvency ratings is the lack of a universal ratings scale. This issue arises because the rating agencies, in essence, are competing with each other and each service tries to be different (Earnshaw, 1993, p. 48) and as such differentiates its results by using its own unique ratings scale.

A.M. Best rating systems follows a scholastic letter rating system with "++", "+", and "-" modifiers, and provides the following scores: A++, A+, A, A-, B ++, B+, B, B-, C++, C+, C, C-, D, E, F. Weiss Ratings, which also follows a scholastic letter rating system, uses only a "+" and "-" modifier to issue the following scores: A+, A, A-, B+, B, B-, C+, C, C-, D+, D, D-, E+, E, E-, F+, F, F-.

Standard & Poor’s and Duff & Phelps use the same “triple A” scale with a “+” and “-” modifier resulting in the following scores; AAA, AA+, AA, AA-, A+, A, A-, BBB+, BBB, BBB-, BB+, BB, BB-, B+, B, B-, CCC, CC, D. Moody’s uses its own “triple A” scale with a numeric modifier to issue the following scores: Aaa, Aa1, Aa2, Aa3, A, A2, A3, Baa1, Baa2, Baa3, Ba1, Ba2, Ba3, B1, B2, B3, Caa1, Caa2, Caa3, Ca1, Ca2, Ca3, C1, C2, C3.

The second issue affecting solvency ratings is that a comparison of the letter ratings between issuers is meaningless. This is because the letter ratings do not follow an intuitive scale and are not used consistently among the rating agencies. An “A+” from one rater is, as one would expect, a rating of the highest standard, whereas the same letter score from another rater could be one of the lowest grade placing the company in the bottom 15% of all life insurance companies.

For example, an “A+” from Weiss is the highest possible score and positions the company as a leader in the industry at the 100 percentile; whereas an “A+” from A.M. Best denotes the second highest score, still generally viewed as an excellent score, ranking the company in the 92.10 percentile. However, an “A+” from Standard & Poor’s is the fifth highest score, placing the company in the 17.27 percentile and is not considered an excellent rating. A “A+” from Duff & Phelps is also a below average rating, which also ranks the company in their fifth highest score as well, but places the ranked organisation in only the 15.74 percentile.

In interpreting the published results of the major life insurance rating agencies, users should not focus on the letter rating without comparing the underlying distribution of the ratings themselves. Earnshaw (1993) argues that the actual rating assigned to the life insurance company is not as important as the relative ranking of the company in relation to other rated companies. He suggests as a result of the lack of a universal scale and with letter ratings neither intuitive nor used consistently among the raters, a better way to look at the ratings is to look at the percentiles that the ratings represent rather, than the score itself.

4.1.7 Life insurance ratings – conclusion

Table 4.1 catalogues the largest rating agencies providing insurance (solvency) ratings, the focus of their ratings and the stakeholders who are affected by their ratings.

Key players	Rating focus	Stakeholders
A.M. Best Company Weiss Ratings	Ranking solvency of insurance companies	Life insurance companies, life insurance policyholders, life insurance agents, regulators and governments.

Table 4.1: Solvency ratings – largest agencies, rating focus and stakeholders

The majority of solvency ratings in the life insurance industry are issued by A.M. Best and Weiss Ratings and are prepared on both a solicited an unsolicited basis. For the stakeholders in the life insurance industry, these ratings provide a convenient mechanism to independently rank the solvency of the life insurance companies. These ratings are used to assess the financial health of life insurance companies and used as an input into the pricing of life insurance policies.

In the next section (section 4.2), this paper will examine the characteristics of the second type of financial rating, the credit rating.

4.2 Credit (corporate default risk) ratings

Risk is the uncertainty as to the outcome of an event. In the context of financial ratings, risk is a measure of default, that is, the uncertainty of repayment. The most common type of risk rating is a credit rating and focuses on the default risk of a corporation.

4.2.1 Credit ratings - scope and purpose

A credit rating represents an assessment of the overall creditworthiness of an obligor in terms of both its capacity and willingness to meet its financial commitments as they fall due (Brooks *et al*., 2003, p.3). Essentially, credit ratings attempt to rate the probability of the risk of default of the corporate issuer.

Credit ratings are useful in understanding the creditworthiness of private sector organisations and public sector agencies.

Credit rating agencies are an integral part of modern capital markets. Their assessments on corporate entities have been increasingly used as benchmarks by regulators, lenders and investors (Ferri & Liu, 2001).

4.2.2 Credit ratings - background and context

The role of credit rating agencies in overseeing corporate financial strength and promoting the operation of capital markets has been a topic of intense interest in the finance literature for more than 20 years (e.g., Weinstein, 1977; Pinches and Singleton, 1978; Holthausen and Leftwich, 1986; Cantor and Packer, 1995, 1997).

Credit ratings are designed to compare the likely risks associated with one issuer to another. Credit issuers (both public and private) place a great deal of importance on their credit rating, as their rating can affect both the perception of the issuer in the market and the economic cost of the issuer's funding (i.e. its cost of capital).

The popularity of credit ratings has boomed since 1990 and today they are so widely employed that many use private sector credit ratings to determine investment prohibitions and capital requirements for institutional portfolio investments (Cantor & Packer, 1997).

Regulators such as the Securities and Exchange Commission (SEC) have used credit ratings by 'internationally recognised' agencies to assess the value of securities held by securities firms, and the amount of capital they must hold (source: www.sec.gov).

Investment institutions, such as banks and life insurers, must by law put most or all of their money into instruments that are investment grade, meaning they are rated between AAA and BBB+ (S&P) or Aaa and Baa1 (Moody's). Increasingly many loan agreements and issuers of debt securities now include rating triggers. If there is a rating downgrade, the interest rate is increased, or sometimes the debt must be repaid immediately.

The trend in using credit ratings is continuing to grow and they are about to acquire even wider influence (Economist, 2002b, p. 69). Under the 1998 Basel Accord proposals for banks' capital requirements, to be applied by 2006 in most developed economies, credit ratings by 'internationally recognised' agencies are to be used to assess the riskiness of a bank's entire portfolio.

4.2.3 Credit ratings – major agencies and methodologies

In rating debt, the risk rating agencies use legions of highly trained analysts with access to top management of the corporations they rate, together with a suite of complex financial valuation models to prepare meticulous credit-rating reports. These reports are designed to give an accurate picture of a firm's riskiness and, ultimately, its probability of default.

There are four players in the international credit rating agency market:

- Standard & Poor's (S&P)
- Moody's Investor Services
- Fitch Ratings
- Thompson

Moody's and Standard & Poor's (S&P) are the two credit-rating agencies that dominate the market, responsible for around 80% of the credit-rating market. Moody's and S&P emerged from relative obscurity in the 1990s to acquire a global reach from their US home base as the major rating agencies (Sinclair, 2003).

Although the individual agencies' ratings are measured on a different scale, there are very broad similarities between them (Brooks *et al.*, 2003, p.3). Table 4.2 below presents the different rating scales (categories) used by each rating agency.

Consolidated Rating Number	Moody's	S&P	Fitch	Thompson
1 (highest credit rating)	Aaa	AAA	AAA	AAA
2	Aa1	AA+	AA+	AA+
3	Aa2	AA	AA	AA
4	Aa3	AA-	AA-	AA-
5	A1	A+	A+	A+
6	A2	A	A	A
7	A3	A-	A-	A-
8	Baa1	BBB+	BBB+	BBB+
9	Baa2	BBB	BBB	BBB
10	Baa3	BB-	BB-	BB-
11	Ba1	BB+	BB+	BB+
12	Ba2	BB	BB	BB
13	Ba3	BB-	BB-	BB-
14	B1	B+	B+	B+
15	B2	B	B	B
16	B3	B-	B-	B-
17	Caa1	CCC+	CCC	CCC
18	Caa2	CCC	CC	CC
19	Caa3	CCC-	C	D
20	Ca	CC	DDD	
21	C	SD	DD	
22 (lowest credit rating)		D	D	

Table 4.2. Comparison of rating agencies credit ratings measures

Table 4.3 below provides a summary description of each of the S&P ratings, as an example of the descriptive terms used by a rating agency to explain each category.

Rating	Definition
AAA	EXTREMELY STRONG capacity to meet financial commitments
AA	VERY STRONG capacity to meet financial commitments – differs from AAA ‘only in small degree’
A	STRONG capacity to meet financial commitments – more susceptible to adverse effects of changes in circumstances and economic conditions
BBB	ADEQUATE capacity to meet financial commitments
BB	LESS VULNERABLE in the near term than other lower-rated obligors. It faces major uncertainties and exposure to adverse business, financial and economic conditions, which could lead to it having an *inadequate* capacity to meet its financial commitments
B	MORE VULNERABLE than BB-rated obligors. Adverse conditions *will likely impair* its capacity or willingness to meets its financial commitments
CCC	CURRENTLY VULNERABLE – dependant on favourable conditions to meet financial commitments
CC	CURRENTLY HIGHLY VULNERABLE
+ / -	Modifies ‘AA’ to ‘CCC’ to show relative standing within major rating categories

Table 4.3: S&P long-term issuer credit ratings (source: Standard & Poor’s)

Credit rating agencies deal closely with issuers of corporate securities and often use both quantitative and qualitative information when formulating their rating of a company’s financial condition (Cantor & Packer, 1995). The information used to establish rankings of financial strength is normally obtained from a combination of both public sources (e.g., annual reports and financial statements) and private information (e.g., managerial statements).

Credit ratings are expressed in either a broad rating category or in descriptive terms. They represent a point-in-time evaluation of the strengths and weaknesses of an issuer, obligor, a proposed financing structure or elements of such structures.

4.2.4 Credit ratings – revenue models

The revenues of the credit rating agencies are derived from (a) revenue from solicited ratings and (b) revenue from sale of subscriptions of data to stakeholders. All the major credit rating agencies provide solicited and unsolicited ratings, and none of the major rating agencies provide co-operative ratings.

The major rating agencies provide both solicited and unsolicited ratings. Solicited ratings are where the issuer seeks ratings from a particular agency. In this case, the issuer will pay the agency to undertake a review, and it will actively participate in the rating process by providing the agency with company-confidential, competitive, financial and strategic information to allow the agency to make an assessment of the overall creditworthiness.

Typically, the issuer will undertake a solicited credit rating where it believes that being rated will assist it in completing a large transaction (such as an acquisition), negotiating favourable terms with a customer or supplier, or attempting to raise funds (bond issue or commercial loan) at a lower cost.

Unsolicited credit ratings are undertaken by a rating agency without active participation or payment from the issuer. Here, the rating agency will make an assessment of creditworthiness based on the issuers published financial information as well as additional information in the public domain.

4.2.5 Credit ratings – stakeholders

The major stakeholders affected by credit ratings include: private sector organisations and public sector agencies who raise capital using debt; regulated investment institutions, such as banks and life insurers; governments and regulators; and retail and institutional investors.

4.2.6 Credit ratings – issues affecting these ratings

The major issues affecting risk ratings are: (1) when rating agencies don't move fast enough to revise their rating as circumstances with a rated company or its market change; (2) when unsolicited ratings may be biased downwards in favour of solicited ratings; and (3) when there is no uniformity of the rating scale and, as such, a comparison of ratings between agencies is often meaningless.

Credit ratings are essentially a qualitative assessment of known risks at a particular point in time. To be meaningful, they need to be continually updated to reflect changes in the circumstances of the issuer and the markets in which they operate.

The largest rating agencies, Moody's and Standard & Poor's, have been criticised for acting too slowly in spotting the declining financial health of companies, particularly in their role of informing the market of updates on corporate bond ratings (eg Ferri, Liu & Stiglitz, 1999).

For example, many investors were holding Enron's investment-grade bonds as their price sank to below that of junk bonds, and those holding Tyco, once a high-flying American conglomerate, were affected by the downgrades that followed when the company had to seek an emergency and costly refinancing, punishing investors (Economist, 2002a, p.69).

Despite investors knowing only too well the limitations of credit ratings, their use as absolute measures by investors and by regulators is increasing not decreasing (Economist, 2002b, p. 69).

There has been considerable controversy over unsolicited credit ratings in recent years. Some dissatisfied issuers allege that unsolicited ratings are biased downward in contrast to solicited ratings. Winnie (2003) conducted an empirical study to analyse the controversy using pooled time-series cross-sectional data of 265 firms in 15 countries from Standard & Poor's during the period 1998-2000.

The results demonstrate that unsolicited ratings are in fact lower. However, it also found that those issuers who choose not to obtain rating services from S&P have weaker financial profiles and, as such, have a lower creditworthiness. The study concluded that the difference in ratings could be explained by this significant self-selection bias.

As Earnshaw (1993) observed with life insurance ratings, in interpreting the published results of credit ratings, users should not focus on the letter rating without comparing the underlying distribution of the ratings themselves.

In analysing the data in Table 4.2 (comparison of rating agencies credit ratings measures) above, what is apparent is that the actual alpha/numeric rating assigned to the credit rating is not as important as the relative ranking of the credit rating in relation to other rating agencies.

As Earnshaw (1993) highlighted in his observations regarding life insurance ratings, the lack of a universal scale also applies to risk ratings and because the letter ratings are not intuitive or used consistently among the rater's, a better way to look at the ratings is to look at the percentiles that the ratings represent, rather than the score itself.

4.2.7 Credit ratings – conclusion

Table 4.4 catalogues the largest rating agencies providing credit ratings, the focus of their ratings and the stakeholders who are affected by their ratings.

Key players	**Rating focus**	**Stakeholders**
Moody’s Investor Service Standard & Poor’s	Ranking the probability of default.	Leveraged corporations and public sector agencies, banks, life insurers, governments and regulators, retail and institutional investors.

Table 4.4: Risk ratings – largest agencies, rating focus and stakeholders

The majority of credit ratings are issued by Moody’s Investor Services and Standard & Poor’s and are prepared on both a solicited an unsolicited basis. For the stakeholders in the credit industry, these ratings provide a convenient mechanism to independently rank the risk of default of leveraged corporations and public sector agencies.

In the next section (section 4.3), this paper will examine the characteristics of the next type of financial rating, the mutual fund rating.

4.3 Mutual fund (performance) ratings

Predicting the future performance of investments is a key outcome of performance ratings. Here, the rating agency attempts to rank the probability of excess volatility-adjusted returns of one investment relative to another in the same asset class. The most prominent type of performance rating is managed fund ratings, which offer a way to monitor the top mutual funds (also known as managed funds or investment funds) within each asset class.

4.3.1 Mutual fund ratings - scope and purpose

Determining which managed fund investment product an investor will choose, or an adviser will recommend to their client, is largely driven by managed fund ratings.

4.3.2 Mutual fund ratings - background and context

Managed funds began in Australia in 1982 when Hill Samuel Australia (now Macquarie Bank) introduced its Cash Management Trust. It has been the fastest growing investment class fuelled by the advent of compulsory employer-funded superannuation. Managed funds in Australia have grown into a $640 billion industry in just 20 years and are expected to top $1 trillion before the end of 2005 (source: www.thebulletin.com.au).

4.3.3 Mutual fund ratings – major agencies and methodologies

While there are many independent rating agencies that focus on servicing the Australian market, there are only a few that cover international markets as well:

- ASSIRT
- Van Eyck
- Rainmaker
- Mercer
- Standard & Poor's
- Morningstar

While rating methodologies differ between agencies, they generally derive their result from an evaluation based on quantitative factors (historic market price performance, volatility in unit price) and qualitative factors (management, experience of fund managers, corporate status and investment process). The underlying view is that managed funds that adhere to disciplined processes and exhibit strong management are more likely, over the long term, to provide consistent above-average volatility-adjusted returns relative to other funds in the same sector.

While Standard & Poor's offers international reach with its managed fund ratings, Morningstar is by far the largest international rating agency covering around 9,500 managers in Australia, Canada, Europe, Finland, France, Germany, Hong Kong, Italy, Japan, Korea, Netherlands, New Zealand, Norway, Spain, Sweden, UK and USA.

The final rating that Standard & Poor's assigns to the fund manager and its funds is a qualitative appraisal based on interviews with the manager and analysis of past returns. The rating scale used is shown in the Table 4.5 below:

Rating	**Explanation**
AAA (highest)	The fund demonstrates the highest standards of quality in its sector, based on its investment process and management's consistency of performance as compared to funds with similar objectives.
AA	The fund demonstrates very high standards of quality in its sector based on its investment process and management's consistency of performance as compared to funds with similar objectives.
A	The fund demonstrates high standards of quality in its sector based on its investment process and management's consistency of performance as compared to funds with similar objectives.
BBB (lowest)	The fund demonstrates above-average standards of quality in its sector, based on its investment process and management's consistency of performance as compared to funds with similar objectives.
NR	Funds designated as NR (not rated) currently do not meet the requisite performance standards and/or the minimum qualitative criteria.
UR (lowest)	Ratings are placed "Under Review" when significant management changes occur at the fund manager or fund management team level, and Standard & Poor's Fund Services has not had the opportunity to re-evaluate its impact upon the qualitative appraisal.

Table 4.5: Explanation of Standard & Poor's Fund Manager Ratings (Source: Standard & Poor's)

Unlike S&P, which uses a scholastic letter-rating system similar to solvency and risk ratings, Morningstar uses an easily identifiable scale from one to five stars to assist investors and their advisers to make better informed decisions about fund managers and their funds.

Morningstar offers a more robust model than S&P, including 50:50 weighting of qualitative (Ql) and quantitative (Qt) rating inputs, and differs significantly with S&P

in that it ranks the universe of funds in a given category by fitting them to a normal distribution curve. The distribution of ratings that corresponds with Morningstar's rating code is show in Table 4.6 below:

Morningstar rating	**Percentage of fund mangers**
★★★★★ (highest)	10.0%
★★★★	22.5%
★★★	35.0%
★★	22.5%
★ (lowest)	10.0%

Table 4.6: Morningstar distribution of ratings (source: Morningstar)

As a result of this statistical distribution process, the rating of all funds in the Morningstar universe will change when any one fund in the universe changes. This dynamic model moves closer towards a real-time assessment and it ensures that the rating issued will be less influenced by the timing the manager chooses to solicit a rating. Morningstar ratings are recalculated and republished at least monthly.

4.3.4 Mutual fund ratings – revenue models

All of these rating agencies provide solicited ratings of fund managers and their funds. The fund manager will pay for the rating agency to provide an assessment of its processes, historical performance and issue a final rating. This is used by the manager to differentiate and promote its managed funds to its stakeholders. None of the major agencies provide unsolicited or co-operative ratings.

4.3.5 Mutual fund ratings – stakeholders

The major stakeholders affected by mutual fund ratings include: institutional and retail investors; investment advisers; asset allocators; fund managers; trustees; and investment product issuers.

4.3.6 Mutual fund ratings – issues affecting these ratings

The issues affecting performance ratings are directed at the S&P rating model and are its (1) selection bias, and (2) its process for re-rating.

The first criticism of the Standard & Poor's model is that the universe of funds it rates is limited to only the top tier managers, based on the size of funds under management (FUM). These mature funds will generally have well-entrenched processes, reliable systems and fund manager succession plans. All of these are attributes that will rate well under the S&P model.

Secondly, the ratings that S&P deliver are not re-rated as new funds are selected into the universe (i.e. the ratings are not normally distributed). As a result, the managers will tend to solicit a rating when they have matured and are at a peak time in their performance. Because of its bias, S&P will tend to deliver A-level ratings for the majority of its solicited ratings.

4.3.7 Mutual fund ratings – conclusion

Table 4.7 catalogues the largest rating agencies providing mutual fund ratings, the focus of their ratings and the stakeholders affected by their ratings.

Key players	Rating focus	Stakeholders
Morningstar Standard & Poor’s	Ranking the probability of excess volatility-adjusted investment returns	Institutional and retail investors, investment advisers, asset allocators, fund managers, trustees, and investment product issuers.

Table 4.7: Performance ratings – largest agencies, rating focus and stakeholders

The majority of mutual fund ratings are issued by Morningstar, with Standard & Poor’s providing ratings limited to the top-tier fund managers. All ratings are issued on a solicited basis, and no ratings are issued on an unsolicited or co-operative basis. For the stakeholders in the mutual fund industry, these ratings provide a convenient mechanism to independently rank the investment performance of mutual funds with the view to identifying which funds in the same asset class could achieve excess future performance.

In the next section (section 4.4), this paper will examine the characteristics of the next type of financial rating, the sovereign rating.

4.4 Sovereign (nation default risk) ratings

Sovereign ratings are an assessment of the relative likelihood that the government of a sovereign nation will default on its obligations to repay debt.

4.4.1 Sovereign ratings - scope and purpose

Like credit ratings, the focus of a sovereign rating is risk. However, the purpose of a sovereign rating is to assess the risk of default, hence the creditworthiness of a sovereign nation, not of a corporation.

4.4.2 Sovereign ratings - background and context

Governments generally solicit credit ratings to ease their own access (and the access of other issuers domiciled within their borders) to international capital markets, where many investors, particularly US investors, prefer rated securities over unrated securities of apparently similar credit risk (Cantor & Packer p. 38).

Sovereign ratings have been available for only a relatively short time, as rating agencies did not start to rate many emerging markets until the mid-1990s when more sovereigns started to issue bonds.

In the past, governments tended to solicit ratings on their foreign currency obligations exclusively, because foreign currency bonds were more likely than domestic currency offerings to be placed with international investors. In recent years, however, international investors have increased their demand for bonds issued in currencies other than traditional global currencies, leading more sovereigns to obtain domestic currency bond ratings as well. To date, however, foreign currency ratings remain the more prevalent and influential of the sovereign ratings (Claessens & Embrechts, 2002).

Sovereign ratings are important not only because some of the largest issuers in the international capital markets are national governments but also because these assessments affect the ratings assigned to borrowers of the same nationality. For example, agencies seldom, if ever, assign a credit rating to a local municipality or provincial government that is higher than that of the issuer's home country.

4.4.3 Sovereign ratings – major agencies and methodologies

To assess the credit risk of governments is not an easy task. One must take into account both solvency facts and aspects, such as the stability of the political system, social cohesion and the degree of interdependence with international, economic and financial systems. Among the factors that might influence the attribution of a higher or lower rating level to each sovereign issuance, one may mention for instance the political stability of the country, the level of external debt, the evidence on previous issuances and eventual defaults, information about the public accounts, indicators of economic performance and the degree of the country development (Afonso, 2002, p.8).

The major issuers of solicited sovereign ratings are:

- Moody's Investor Services
- Standard & Poor's

Together the agencies rate more than 50 sovereigns and although the agencies use different symbols and methodologies in assessing credit risk, every Moody's rating has an equal counterpart in Standard & Poor's rating scale.

4.4.4 Sovereign ratings – revenue models

The revenues of the sovereign rating agencies are derived from (a) revenue from solicited ratings and (b) revenue from sale of subscriptions of data to stakeholders. All the rating agencies provide solicited and unsolicited ratings, with none of the agencies providing co-operative ratings.

4.4.5 Sovereign ratings – stakeholders

The major stakeholders affected by sovereign ratings include: institutional investors and lenders; national governments and their state and municipal agencies; central banks; and regulators.

4.4.6 Sovereign ratings – issues affecting these ratings

The major issue affecting sovereign ratings is accuracy, due to the following identified issues: (1) bias in sample size; (2) default history; and (3) timing of any re-ratings.

Montfot & Mulder (2000) concluded that the coverage of sovereign ratings in terms of countries is relatively limited, and the sample size is probably biased as only those countries with market access are being rated. As a result of this bias in the sample size, the accuracy of the sovereign ratings as a true measure of global creditworthiness is questionable.

Montfot & Mulder (2000) also observed that few rated countries have experienced serious payment difficulties, and because of this compliant history, making assessment of future default probabilities is difficult, if not impossible.

Finally, Ferri, Liu & Stiglitz (1999) studied emerging markets following the Asian financial crises and observed that sovereign ratings are lagging indicators. As a result of this observation, they question the accuracy of sovereign ratings as a reliable measure of current or even future creditworthiness.

4.4.7 Sovereign ratings – conclusion

Table 4.8 catalogues the largest rating agencies providing sovereign ratings, the focus of their ratings and the stakeholders who are affected by their ratings.

Key players	**Rating focus**	**Stakeholders**
Moody's Investor Services Standard & Poor's	Ranking the probability of risk of default by a sovereign nation	National governments and their state and municipal agencies, institutional investors and lenders, central banks and regulators

Table 4.8: Sovereign ratings – largest agencies, rating focus and stakeholders

Sovereign ratings are issued by Moody's Investor Services and Standard & Poor's. These ratings are issued on a solicited and unsolicited basis, and no ratings are issued on a co-operative basis. For the stakeholders, these ratings provide a mechanism to independently rank the default risk of sovereign nations, although the literature suggests that the rating methodology may be inherently unreliable.

In the next section (section 4.5), this paper will examine the characteristics of the next type of financial rating, the recently introduced corporate governance rating.

4.5 Corporate governance (performance) ratings

In response to an increased demands for disclosure and transparency several new rating agencies have emerged and introduced rating methodologies focusing on the performance of corporate governance within an organisation.

4.5.1 Corporate governance ratings - scope and purpose

The focus of these specialised rating agencies is to evaluate the information and decision systems within an organisation to judge how effective they are at ensuring proper accountability, probity and openness in the conduct of the organisation's business.

From the investor's and lender's perspective, corporate governance ratings are a useful selection or screening tool because in the wake of so many corporate collapses (such as Ansett, HIH, OneTel, Enron, WorldCom, Anderson, Parmalat, etc.), many believe that investing in companies with a commitment to good corporate governance results in fewer risks (McKinsey & Company, 2000).

4.5.2 Corporate governance ratings - background and context

Several empirical studies have emerged in the academic literature to suggest there may be a correlation between strong corporate governance and the improved long-term performance of an organisation (Bauer, Gunter & Ottenm 2003; Grompers, Ishii & Metrick, 2003; Brown and Caylor, 2004).

4.5.3 Corporate governance ratings – major agencies and methodologies

The major rating agencies specialising in corporate governance ratings include;

- Deminor Corporate Governance Rating Service
- GovernanceMetrics International (GMI)
- ISS Corporate Governance Quotient (ISS)
- Standard & Poor's (S&P)
- Investor Responsibility Research Center (IRRC)

GMI and Standard & Poor's (S&P) are the largest agencies providing governance ratings internationally. The proprietary rating methodologies used by each rating agency vary to such an extent that it is not possible to have any meaningful comparison between the ratings published by each agency.

4.5.4 Corporate governance ratings – revenue models

Deminor Corporate Governance Rating Service provides solicited corporate governance ratings as well as unsolicited ratings of companies comprising the FTSE Eurotop 300 index.

The Investor Responsibility Research Centre (IRRC) provides unsolicited corporate governance ratings of the 1,500 leading US companies.

Institutional Shareholders Services (ISS) provides a rating system to assist institutional investors in evaluating governance practices. While there is no charge to companies that are rated for the service, ISS analyses are delivered to its client base of more than 750 institutions (Wilson, 2004, p. 25).

GovernanceMetrics International (GMI) assesses the governance practices of companies in North America, Europe and Asia. Annual subscriptions to GMIs rating services start at $US18,000 a year and it offers a comprehensive analysis to participating companies for $US50,000 (Wilson, 2004, p. 25).
S&P charges companies between $US18,000 and $US150,000 for its solicited corporate governance rating service. The S&P ratings model is not as impartial as the GMI model because after the S&P ratings analysts assign a score, the rated company decides whether to make the ratings public. Therefore, S&P would be seen as less acceptable as it is not in control of independently issuing or modifying the rating.

4.5.5 Corporate governance ratings – stakeholders

The major stakeholders affected by corporate governance ratings include large organisations, such as listed companies and multinational corporations, and their institutional investors.

4.5.6 Corporate governance ratings – issues affecting these ratings

Two issues that affect governance ratings are: (1) reliability; and (2) cost. While corporate governance is seen as essential to ensuring accountability and disclosure to stakeholders, it in itself is only one contributing factor to the overall performance of an organisation. Accordingly, using a governance rating in isolation to predict future performance may be unreliable.

Because of the high cost of subscribing to these ratings services, institutions will be the primary beneficiaries because they can afford access to the reports, while retail investors would typically be excluded.

4.5.7 Corporate governance ratings – conclusion

Table 4.9 catalogues the largest rating agencies providing corporate governance ratings, the focus of their ratings and the stakeholders who are affected by their ratings.

Key players	Rating focus	Stakeholders
GovernanceMetrics International Standard & Poor’s	Ranking the probity of information and decision-making systems	Listed companies, multinational corporations and institutional investors

Table 4.9: Corporate governance ratings – largest agencies, rating focus and stakeholders

The majority of corporate governance ratings are issued by GovernanceMetrics International and Standard & Poor’s. While both provide solicited ratings, GovernanceMetrics International also provides limited unsolicited ratings. None of the companies provide co-operative ratings.

For the stakeholders, these ratings provide a mechanism to independently rank the performance of an organisation by focusing exclusively on its internal governance structures.

While there has been increasing investor preference for reliable governance structures in organisations, a corporate governance rating alone may not be reliable as the single metric to predicting future performance. A more comprehensive approach to rating performance that incorporates corporate governance as one element, is the sustainability rating.

4.6 Sustainability (performance) ratings

In responses to changes in attitudes to responsible corporate behaviour and concerns about the sustainability of finite resources, a new ratings type has emerged that focuses on the performance of an organisation in meeting the societal needs of stakeholders - this is known as CSR or *Sustainability* (see section 5 for more details).

4.6.1 Sustainability ratings - scope and purpose

Sustainability ratings rank an organisations in terms of the expectations of stakeholders while maintaining sustainable financial, environmental and social performance. These ratings provide an assessment of an organisation's ability to deliver a sustainable future.

4.6.2 Sustainability ratings - background and context

Building upon the role that corporate governance systems play in organisational performance, CSR takes a wider view to incorporate other management systems, such as social, environmental and workplace. Sustainability builds further upon these theme's ensuring that these underlying management system are self-managing and reliable, plus it incorporates the financial aspect of self-sufficiency. Increasingly, the role of CSR and sustainability is emerging in the academic literature as a desirable basis of delivering long-term performance to an organisation (Fowler, 2002; Mays, 2003; Caswell, 2004).

4.6.3 Sustainability ratings – major agencies and methodologies

The only international issuer of sustainability ratings found in the review was RepuTex.

RepuTex social responsibility ratings measure organisational performance of the top 100 organisations (private and public sector) in Australia and New Zealand (RepuTex, 2003). These ratings are provided on a co-operative and unsolicited basis.

The RepuTex ratings model appraises the areas of corporate governance, environmental impact, social impact and workplace practices, requiring organisations to demonstrate long-term social commitment in response to community-based expectations. The corporate governance performance is appraised according to the ability to self-govern and self-regulate on an ethical, reliable, sustainable and socially acceptable basis. Standards of auditing, reporting, risk management and long-term commitment to financial stakeholder return are taken into consideration.

The environmental impact rates the ability of an organisation to be publicly accountable for its environmental performance through open and transparent reporting. This includes revealing strategies to minimise negative impact, investment policies, stakeholder consultation and stewardship for the future. For the social impact performance is appraised according to an organisation's transparency in reporting on its local and global policies towards human rights, customers, disadvantaged people, educational partnerships, the arts, culture and community support programs.

The workplace practices are examined through areas such as occupational health and safety, openness in reporting on organisational culture and whistle blowing systems, as well as management and training systems. Remuneration policies for the whole of the organisation, including the board of directors, are expected to be fair. The ability to report on the impact of employment policies on the wider community is also appraised.

Organisations are rated on a scholastic scale of AAA (the highest) to D. The AAA rating suggests high standards of social responsibility in policy and practice embedded throughout an organisation's culture.

4.6.4 Sustainability ratings – revenue models

The RepuTex ratings are provided on a co-operative and unsolicited basis, ensuring that the rating agency is not paid by the company it rates. The revenue that RepuTex generates is exclusively from the sales of subscription data to its subscribers.

4.6.5 Sustainability ratings – stakeholders

Subscribers to RepuTex ratings include corporations and government agencies that are interested in benchmarking, and institutional investors who may have a socially responsible investment bias.

4.6.6 Sustainability ratings – issues affecting these ratings

The major issue affecting this rating is the inconsistency in social reporting among the rated companies. Because there is no generally accepted framework for social disclosure, some companies may provide higher levels of transparency than others in their reporting. When the rating is prepared on an unsolicited basis (as opposed to a co-operative basis), there may be limited information in the public domain to provide a reliable and acceptable assessment about an organisations sustainability performance. This problem is compounded where reputation performance of the company is ranked relative to other companies who may have higher levels of disclosure, or, who may be co-operating with the rater and providing additional non-public information.

As a result of this inconsistency in the levels of reporting among organisations, there may be an upward bias in the ratings for those who voluntarily adopt more rigorous social disclosure, using frameworks such as the Global Reporting Initiative (GRI).

4.6.7 Sustainability ratings – conclusion

In summary, table 4.10 catalogues the only international rating agency providing sustainability ratings, the focus of their ratings and the stakeholders who are affected by their ratings.

Key players	Rating focus	Stakeholders
RepuTex	Ranking the performance in meeting societal expectations	Large public and private companies, government agencies and institutional investors.

Table 4.10: Sustainability ratings – largest agency, rating focus and stakeholders

As indicated above, these ratings are provided on a co-operative and unsolicited basis and therefore have a high degree of independence and acceptability.

For stakeholders, these ratings provide an insight into the performance of an organisation in meeting its societal expectations of maintaining sustainable financial, environmental and social performance, and provide an assessment of the organisations' ability to continue with a sustainable future.

When the ratings are prepared on an unsolicited basis where the rater relies solely upon publicly disclosed information, there may be an upward bias in the ratings result where organisations voluntarily adopt higher levels of transparency and social reporting in their public disclosure.

In the next section (section 4.7), the paper will conclude with some general observations about the major rating agencies operating across each of the six typologies.

4.7 Observations about the major international rating agencies

The major financial ratings can be categorised across six rating types; insurance, credit, mutual fund, sovereign, corporate governance and sustainability. The respective focus of each of these typologies is solvency, default risk of a corporation, investment performance, default risk of a sovereign state, organisational performance and sustainable performance.

Table 4.11 (below) catalogues the 17 major international rating agencies across the six ratings typologies and identifies the rating type as solicited, unsolicited or co-operative. This classification of methodology not only describes the relationship between the rating agency and the rated organisation, it also gives an assessment of the independence of the rating agency and ultimately the acceptability of the rating opinion.

Of these 17 agencies, seven provide ratings solely on a solicited basis, a further seven provide both solicited an unsolicited ratings, two provide ratings on an unsolicited basis only, and only one rating agency provides unsolicited and co-operative ratings. This finding is significant as it suggests that the majority of international rating agencies are providing ratings using methodologies that are unacceptable.

The empirical evidence catalogued in table 4.11 also supports the literature claims that Moody's Investor Services and Standard & Poor's are the major international rating agencies (Cantor & Packer, 1994) covering three rating types and five rating types respectively.

It is also apparent from table 4.11 that there is a patterning of rating types between agencies. 14 of the 17 agencies are *specialists*, providing ratings of only one type, and three are *generalists* providing ratings across two or more types. The most popular rating type is mutual fund ratings with seven rating agencies in total, comprising five specialist and two generalist rating agencies. The concentration of rating agencies around this rating type is largely attributed to the rapid growth in mutual fund investment.

International Rating agencies	Insurance	Credit	Mutual Fund	Sovereign	Corporate Governance	Sustainability
A.M. Best Company	Solicited & Unsolicited	-	-	-	-	-
ASSIRT	-	-	Solicited	-	-	-
Deminor Corporate Governance Rating Service	-	-	-	-	Solicited & Unsolicited	-
Duff & Phelps	Solicited	-	-	-	-	-
Fitch Ratings	-	Solicited & Unsolicited	-	-	-	-
GovernanceMetrics International (GMI)	-	-	-	-	Solicited	-
Investor Responsibility Research Center (IRCC)	-	-	-	-	Unsolicited	-
ISS Corporate Governance Quotient	-	-	-	-	Unsolicited	-
Mercer	-	-	Solicited	-	-	-
Moody's Investor Services	Solicited	Solicited & Unsolicited	-	Solicited & Unsolicited	-	-
Morningstar	-	-	Solicited	-	-	-
Rainmaker	-	-	Solicited	-	-	-
RepuTex	-	-	-	-	-	Unsolicited & Co-operative
Standard & Poor's (S&P)	Solicited	Solicited & Unsolicited	Solicited	Solicited & Unsolicited	Solicited	-
Thompson	-	Solicited & Unsolicited	Solicited	-	-	-
Van Eyck	-	-	Solicited	-	-	-
Weiss Ratings	Solicited & Unsolicited	-	-	-	-	-
n=17	**5**	**4**	**7**	**2**	**5**	**1**

Table 4.11: Major international rating agencies by rating type and classification of independence

Currently, there is an only one specialist international rating agency providing sustainability ratings. This is a significant finding as it demonstrates there is a major lack of attention to sustainability by the international rating agencies.

However, sustainability is emerging as a major issue in the academic literature and public policy debate, and this may be a catalyst for more rating agencies to introduce future services focusing on this typology.

Market indices have been quick to focus their attention on the growing trend in sustainability. Many have already developed products to measure the performance of listed companies globally that have embraced sustainability in practice. Although these are not rating products, they are useful as a screening tool to help identify best-practice listed companies in this field, and track their market performance.

Section 5 will now look at the academic literature surrounding sustainability and, highlight the role that disclosure plays in satisfying stakeholder demand. This will be followed by an analysis in section 6 which will look at the various disclosure frameworks that organisations can voluntarily adopt to satisfy this stakeholder demand, and meet their disclosure requirements. In section 7, the paper will examine the sustainability indices and analyse their selection criteria.

SECTION 5: CSR & SUSTAINABILITY

The am of this section is to briefly explore the literature regarding sustainability and extended reporting frameworks.

The section starts in 5.1 by defining *corporate social responsibility (CSR)* and *sustainability* and adopting the view that these terms have similar meanings and are often used interchangeably to mean the same thing. Section 5.2 outlines a brief overview of the historical development of the concepts of sustainability, which will lead into an analysis of the five major frameworks covered in the literature: (1) agency view; (2) corporate social performance view; (3) resource-based view; (4) supply and demand view; and (5) the stakeholder view, which is the dominant view. Section 5.3 looks at understanding stakeholders and their importance in sustainability. Finally, section 5.4 concludes with some observations about sustainability frameworks, and the motivations of companies for increased disclosure with their stakeholders.

5.1 Defining CSR and sustainability

Corporate Social Responsibility (CSR) is defined as operating a business on a reliable, sustainable and desirable basis that respects ethical values, people, communities and the environment (Anderson, 1989). The focus on this definition suggests a short-run view focusing the attention of the company on current issues. There are four constituent components (RepuTex, 2003) that together influence an organisation's ability to be socially responsible: (1) environmental impact; (2) corporate governance; (3) social impact; and (4) workplace practices.

Consistent with the definition that has been adopted in this paper, the terms CSR and sustainability are used inter-changeably to mean the same thing (e.g. Caswell, 2004). This is because CSR is a sub-set of sustainability (see figure 7.1 below). For any organisation to be sustainable in the long term it firstly needs to be financially self-sufficient. Once this primary need for financial capital has been met, the organisation then needs to be socially responsible. This is achieved by ensuring that its governance and workplace practices and its environmental and social impact are self-monitoring and conform to society's expectations and ethical values. Only then can a company achieve sustainability in the long term.

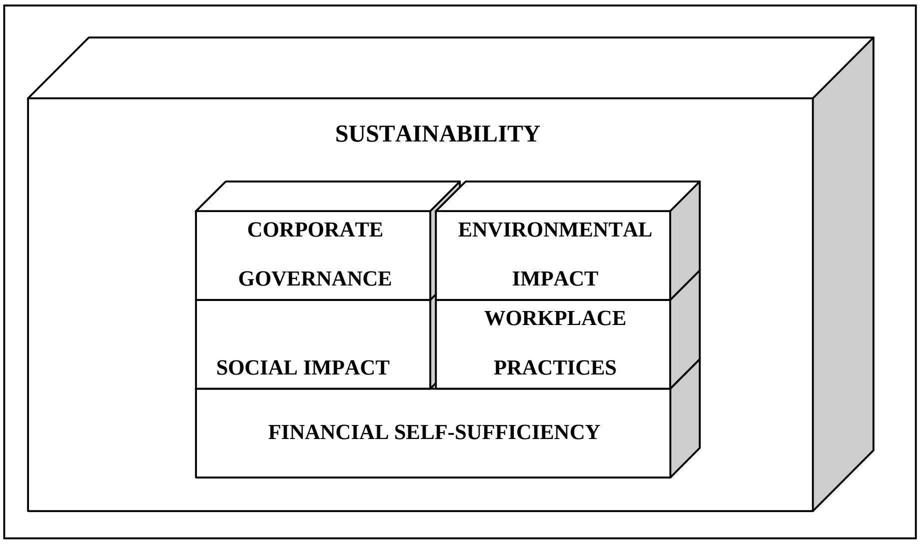

Figure 7.1: Relationship between sustainability and financial self-sufficiency

The next section will look at the historical development of these concepts and a review of the literature.

5.2 Historical development of sustainability

The concept of social responsibility, or social responsiveness, is an evolving concept (Mays Report, 2003, p.12) and means different things to different stakeholders (Arlow & Gannon, 1982). However, the concept of social responsibility has been with us since the beginning of mankind (Anderson, 1989).

A comprehensive approach to Western contemporary social responsibility came in 1953 with the publication of Howard R. Bowen's book, *Social Responsibilities of the Businessman*. Here, Bowen described the social responsibility of the businessman as "the obligation of businessmen to pursue policies, to make those decision, or to follow those lines of action which are desirable in terms of objectives and values in our society" (Bowen, 1953, p.6).

The CED (1971) used the term "social contract" to define the relationship between business and society with business's major obligation being the provision of goods and services for the benefit of society.

A significant amount of research has been undertaken over the past decades in understanding the nature of and motives for corporate social responsibility (e.g. Anderson, 1989; Arlow & Gannon, 1982; Carroll, 1979; Clarkson, 1995; McWillians & Siegel, 2001; Pava & Krausz, 1996; Waddock & Graves, 1997; Wood, 1991) Increasingly, the importance placed on corporate social responsibility by investors, analysts, commentators and academics has grown, indicating a shift in attitudes.

This shift in attitude started with the Agency view, which is the first framework identified in the literature. The next framework in the literature is the Corporate Social Performance (CSP) view, followed by the Resource-based view (RBV), the Supply and Demand view, and finally the Stakeholder view is identified.

5.2.1 The agency view

Initially, the idea that a corporation was using shareholders' funds to engage in social projects was criticised (Gelb & Stawser, 2001, p. 3).

Freidman (1962, 1970) is generally credited with the "agency view" of the corporation and its responsibility to society. Freidman, recipient of the 1976 Nobel Memorial Prize for economic science, proposed that engaging in CSR is symptomatic of an agency problem or a conflict between the interests of managers and shareholders. Freidman argues that managers use CSR as a means to further their own social, political or career agendas, at the expense of shareholders (McWillans & Siegel, 2001, pp. 118).

According to Friedman's agency view, the business entity is accountable only to its shareholders and its sole social responsibility is to maximise the value of the firm (Gelb & Stawser, 2001, p. 3). To paraphrase from *Capitalism and Freedom* (Freidman, 1962, pp. 133-135);

> "The view has been gaining widespread acceptance that corporate officials and labour leaders have a 'social responsibility' that goes beyond serving the

> interest of their stockholders and their members…Few trends could so thoroughly undermine the very foundation of our free society as the acceptance by corporate officials of a social responsibility other than to make as much money for their stockholders as possible. This is a fundamentally subversive doctrine…The claim that business should contribute to the support of charitable activities…is an inappropriate use of corporate funds in a free enterprise society."

The agency view started to lose favour in the literature as the corporate social performance view gained attention in the 1980's.

5.2.2 The corporate social performance (CSP) view

Early research by Preston (1978) and Carroll (1979) outlined a "corporate social performance" (CSP) framework, which includes the philosophy of social responsiveness, the social issues involved, and the social and economic responsibilities. Waddcock and Graves (1997) empirically tested the CSP model and reported a positive association between CSP and financial performance (McWillams & Siegel, 2001, p. 118). Researchers such as Pava and Krausz (1996) hypothesized that, according to the agency view, greater levels of CSR would lead to reduced levels of financial performance. Their findings persistently showed the opposite: that firms perceived as socially responsible performed as well as or better than their counterparts that do not engage in costly social activities. The authors concluded that "sometimes a conscious pursuit of corporate social responsibility goals causes better financial performance" (Pava and Krausz, 1996, p. 333).

Building upon Preston & Carroll's framework, another view, the Resource-based View (RBV) argues that CSP not only improves financial performance but it also adds a competitive advantage to the firm.

5.2.3 Resource-based view (RBV)

Another framework has been developed by Russo and Fouts (1997). They examined CSR from a "resource-based view" (RBV) of the firm perspective. Using this framework, they argue that CSP (especially environmental performance) can constitute a competitive advantage, especially in high-growth industries

Using the RBV framework as a foundation, the next framework, the supply and demand view, introduced the notion of optimising sustainability investment.

5.2.4 Supply and demand view

McWillans & Siegel (2001) developed a 'supply and demand' framework and proposed that there is a level of CSR investment that maximises profit, while also satisfying stakeholder demand for CSR. While focusing the level of CSR investment is seen as important to maximise profits, the literature favours stakeholders as the primary focus.

5.2.5 Stakeholder View

A widely used framework for examining CSR is the "stakeholder" perspective. Developed by Freeman (1984), the stakeholder theory asserts that firms have relationships with many constituent groups and that these stakeholders both affect and are affected by the actions of the firm. Freeman (1984) argued that systematic attention to stakeholder interest is critical to firm success and management must pursue actions that are optimal for a broad class of stakeholders, rather than those that serve only to maximise shareholder interests (Gelb & Stawser, 2001, p. 3).

5.3 Understanding stakeholders

Freeman (1984, pp. 46) defines a stakeholder as "…any group or individual who can affect or is affected by the achievements of an organisation's objectives". This definition is still widely acknowledged as the landmark position in stakeholder theory (Wood, 1991; Clarkson, 1995, Vos, 2003). The distinction between those who "can affect" (i.e. the involved) and "is affected" (i.e. the affected) is considered crucial in understanding and defining stakeholders. The involved have the possibility to directly influence the actions of the firm, while the affected do not have any influence over the actions of the firm.

From the firm's perspective, stakeholder identification is not easily solved, it comprises, at least, a modelling and a normative issue (Vos, 2003, p.141). The modelling issue refers to identification issues for management, such as "who are our stakeholders?" and "to what extent can we distinguish between stakeholders and non-stakeholders?". The normative issue refers to managerial implication, such as "what stakeholders will we take into account?" or "to what stakeholders are we willing to listen?". Vos (2003) argues that to identify stakeholders, both the modelling and the normative issue need to be resolved.

Mitchell *et al*. (1997) stresses the importance of risk in identifying stakeholders and points out that without risk, there is no *stake* (a stake in this sense is something that can be lost). As such, a stakeholder is a risk-bearer and from this perspective, the distinction can be made between voluntary and involuntary stakeholders. Voluntary stakeholders bear some form of risk as a result of having invested some form of capital (human or financial) or something of value in the firm. Involuntary stakeholders are placed at risk as a result of the firm's activities (Mitchell, *et al*., 1997).

The dominance of the shareholder among all stakeholders is consistent with Friedman's (1962, 1970) agency view, which largely is seen as untenable in the context of CSR. There is no denying that shareholders deserve their special position as voluntary stakeholders because of the property rights they enjoy with the organisation, and the fiduciary duty (which us based on trust) between management and the shareholders. However, the organisation should acknowledge that it also owes a moral obligation to all non-shareholder stakeholders (including involuntary stakeholders) where the freedom and well-being of stakeholders in affected by the organisation's activities (Goodpaster, 1998).

Donaldson and Preston (1995) refined the stakeholder paradigm by arguing that three aspects of this theory – normative, descriptive/empirical and instrumental – are "mutually supportive". Jones and Wicks (1999) propose converging the instrumental (social science) and normative (ethics) components of stakeholder theory to arrive at a normative theory that describes how managers can create morally sound approaches to business and make them work (Jones and Wicks, 1999, p. 206). For more recent developments in stakeholder theory, see Gelb & Stawser (2001).

To a certain extent, the management of CSR has become stakeholder management (Donaldson & Preston, 1995). In dealing with stakeholder identification and management, there are two generally accepted positions: the firm-centred or instrumental perspective; and the system-centred or social responsibility framework (Vos, 2003, p. 144).

The firm-centred or instrumental perspective (Vos, 2003) is where the organisation identifies all its stakeholders for firm-centred purposes, such as economic prosperity, risk management, economic dependency, brand and image building. In general, these are the 'involved' stakeholders who can potentially affect the organisations achievements.

Using stakeholder theory as a dominate paradigm, CSR may be defined as either:

(a) the obligation or duties of an organisation to a specific system of stakeholders (Vos, 2003); or,

(b) actions that appear to further some social good, beyond the interest of the firm and that which is required by law to do so (McWillans & Siegel, 2001).

CSR means going beyond obeying the law; merely abiding by the law does not necessarily constitute a CSR activity. Some examples of CSR actions include going beyond legal requirements in adopting progressive human resource management programs, developing non-animal testing procedures, recycling, abating pollution, supporting local businesses, and embodying products with social attributes or characteristics such as product or process innovation" (McWillans & Siegel, 2001, pp. 117).

5.4 Summary

Over the past few decades, the attitudes of some companies have changed, rejecting the agency view (Freidman, 1962, 1970), instead embracing stakeholders (Freeman, 1984) and sustainability concepts in their business practice.

This has been motivated by a belief that adopting sustainability practices in the long-run will lead to the improved financial performance of the firm (McWilliams & Siegel, 2001; Pavca & Krausz, 1996), increased competitive advantage (Russo & Fouts, 1997), profit maximisation (McWilliams & Siegel, 2001) and the long-term success of the firm (Freeman, 1984).

To achieve these goals, companies need to demonstrate to their stakeholders that they are meeting or exceeding those stakeholders' expectations of performance in the area of sustainability. To facilitate this, companies have adopted new reporting and disclosure frameworks to help them communicate with their stakeholders. These frameworks will be examined in the next section.

SECTION 6: VARIOUS SUSTAINABILITY FRAMEWORKS AND REPORTING

The aim of this section is to briefly explore the extended reporting frameworks. Section 6.1 below will briefly outline the background to the development of new reporting frameworks by examining the academic literature in the area of sustainability research. The literature suggests that the traditional financial accounting framework is too narrow (Guthrie & Parker, 1993) and the suggestion has attracted increasing interested in the area of social reporting. To this end, a number of new reporting and social accounting guidelines have been developed and they are catalogued in table 6.1. Next, section 6.2 will focus on the development of one particular framework, the Global Reporting Initiative (GRI). 6.3 will catalogue the Australian organisations that have voluntarily adopted the GRI framework for their sustainability disclosure.

6.1 The introduction of new reporting frameworks

Traditional accounting has long been criticised for providing an incomplete account of business. It fails to present the dynamics of business-value-creating activities and how politico-socio factors may affect or be affected by business value creating activities. This is evidenced by increasing research in Intellectual Capital Reporting (ICR) and Corporate Social Responsibility Reporting (CSR) and the introduction of new disclosure frameworks.

From the perspective of the CSR research, the traditional financial accounting framework is too narrow (Guthrie & Parker, 1993). The business income concept needs to be expanded (Bedford, 1965) because economic performance is not an index of total welfare (Bedford, 1965; Pigou, 1938). Since business activities have both economic and social impacts (Estes, 1976), businesses must meet societal expectations of both profit generation and contributions to the quality of life in general. This is also consistent with the concept of social contract of the legitimacy theory (CED, 1971).

A plethora of alternative reporting methods have been proposed in the sustainability literature (see Table 6.1 below), however there is no universally accepted framework.

1	The Balanced Scorecard *The Balanced Scorecard: Translating Strategy into Action* (1996; based on a 1992 article) – Professor Robert S. Kaplan and David P. Norton
2	The Jenkins Report *Improving Business Reporting – A Customer Focus* (1994) – American Institute of Certified Public Accountants
3	Tomorrow's Company *Tomorrow's Company: The Role of Business in a Changing World* (1995) – Royal Society of Arts and *Sooner, Sharper, Simpler: A Lean Vision of an Inclusive Annual Report* (1998) – Centre for Tomorrow's Company
4	The 21st Century Annual Report *The 21st Century Annual Report/Prototype plc* (1998) and *Performance Reporting in the Digital Age* (1998) – both ICAEW
5	The Inevitable Change *Business Reporting: The Inevitable Change?* (1999) – ICAS
6	Inside Out *Inside Out: Reporting on Shareholder Value* (1999) – ICAEW
7	Value Dynamics *Cracking the Value Code: How Successful Businesses are Creating Wealth in the New Economy* (2000) – Arthur Andersen
8	GRI *Sustainability Reporting Guidelines* (2000; revised 2002) – Global Reporting Initiative
9	The Brookings Institution *Unseen Wealth: Report of the Brookings Task Force on Understanding Intangible Sources of Value* (2001) and Professor Baruch Lev's *Intangibles: Management, ,Measurement, and Reporting* (2001) – both Brookings Institution
10	ValueReporting *The ValueReporting Revolution: Moving Beyond the Earnings Game* (2001) and *Building Public Trust: The Future of Corporate Reporting* (2002) – both PricewaterhouseCoopers
11	The Hermes Principles *The Hermes Principles: What Shareholders Expect of Public Companies – and What Companies Should Expect of Their Investors* (2002) – Hermes Pensions Management Limited

Table 6.1 New reporting frameworks
(Source: ICAEW, 2004, p. 9)

The idea to combine extended reporting frameworks with the traditional financial accounting framework has recently attracted a great deal of attention. One example of this synergy is the Triple Bottom Line reporting approach (TBL).

TBL, a term coined by Elkington (1980), focuses "corporations not just on the economic value they add, but also on the environmental and social value they add – and destroy". The idea is rooted in the concept, and goal, of sustainable development, which is defined as "development that meets the needs of the present world without compromising the ability of future generations to meet their own needs" (WCED, 1987). As Deegan (1999) indicated, "for an organisation or community to be sustainable (a long-run perspective), it must be financially secured (as evidenced through such measures as profitability); it must minimise (or ideally eliminate) its negative environmental impacts; and it must act in conformity with society's expectations". That is, it is inadequate to measure and present only economic performance, which is the focus of the Intellectual Capital (IC) research. To be sustained in the long-run, organisations must strive to achieve better performance across the three dimensions of TBL.

An alternative is the codification of guidelines such as the Global Reporting Initiative 2002 guidelines, which is an initiative that is heading towards a common and acceptable reporting framework aiming to combine the reporting of financial, environmental and social performance within the same format (Environment Australia, 2000). In addition, as stated in GRI (2002), the initiative has enjoyed the active support and engagement of representatives of key constituencies and the guideline provides the most updated, in the GRI's view, of a consensus on a reporting framework at this point.

6.2 Triple bottom line and development of GRI

The publication of *Cannibals With Forks* (Elkington, 1997) focused the business community on the links between environmental, economic and social concerns that had been highlighted previously in the Brundtland Report (WCED, 1987). Elkington coined the term ‘Triple Bottom Line’ and has convinced many leading companies to embrace sustainability using his Triple Bottom Line theory. The GRI builds upon the foundations of Triple Bottom Line to provide a framework for reporting and social accounting.

The Coalition for Environmentally Responsible Economies originally launched the *Global Reporting Initiative* (GRI) in 1997. The GRI is a voluntary set of guidelines for reporting on the economic, environmental and social aspects of an organisation’s activities.

The GRI was established with the goal of enhancing the quality, rigour and utility of sustainability reporting. The initiative has enjoyed the active support and engagement of representatives from business, NGOs, accounting bodies, investor organisations and trade unions. Together, these different constituencies have worked to build a consensus around a set of reporting guidelines with the objective of obtaining worldwide acceptance (Fowler, 2002).

The sustainability reporting guidelines are a framework for reporting on economic, environmental and social performance. They (a) outline reporting principles and content to help prepare organisation-level sustainability reports; (b) help organisations gain a balanced picture of their economic, environmental and social performance; (c) promote comparability of sustainability reports; (d) support benchmarking and assessment of sustainability performance; and (e) serve as a key tool in the overall process of stakeholders' engagement.

Sometimes referred to as triple bottom line reporting, the term sustainability reporting is used throughout the GRI guidelines.

The guidelines can be used simply as an informal reference document to assist organisations in developing a framework and indicators for measurement and reporting in an environmental fashion. Alternatively the organisation may choose to adopt them and prepare their report 'in accordance' with the guidelines.

The GRI recognises the complexity of implementing a sustainability reporting program and the need for many organisations to build their reporting capacity in an incremental fashion. Such organisations may choose not to prepare a complete GRI-based report in their initial effort. Instead, they may choose a step-by-step approach to adopting the guidelines over a period of time.

Increasingly, these voluntary guidelines are being adopted by companies worldwide, providing a common framework for sustainability reporting. This increasing trend with global companies can also be seen in the increased application of GRI among Australian organisation.

6.3 Australian application of GRI

A number of companies around the world have released reports indicating that they have referred to and followed the guidelines in preparing their disclosure reports. These include 22 Australian organisations, and along with their sector, are listed in table 6.2 below:

Organisation	Sector
Ford Australia - Broadmeadows Assembly Plant	Automotive
Toyota Australia	Automotive
Australian Ethical Investment	Financial services
Westpac Banking Corporation	Financial services
Port of Brisbane Corporation	Logistics
QCL Group Construction	Materials
Newcrest	Mining
WMC Resource Ltd	Mining
Argyle Diamonds	Mining
BHP Billiton	Mining
MIM Holdings	Mining
Visy Industries Forest and Paper Products	Mining
Landcare Australia	Non-Profit/Services
Australian Commonwealth Department of Family & Community Services (FaCS)	Public Agency
Telstra	Telecommunications
British American Tobacco Australia	Tobacco
City West Water	Utilities
Energex Limited Energy	Utilities
Integral Energy	Utilities
Loy Yang Power Energy	Utilities
Sydney Water	Utilities
Tarong Energy	Utilities

Table 6.2: 22 Australian GRI reporters (Source: www.globalreporting.org)

An analysis of this data shows that the Mining (6) and Utilities (6) sectors are the most represented sectors in Australia, with 12 organisations adopting GRI reporting.

6.4 Summary of sustainability reporting frameworks

There has been growing concern in the academic literature that the traditional financial disclosure framework by organisations is insufficient because: (a) it has failed to adapt to the changing nature of business; (b) that it no longer meets the changing needs of investors; and (c) that it fails to recognise a wide enough circle of users (ICAEW, 2004, p.6). In attempting to satisfy this deficiency in traditional reporting, a number of new alternative sustainability reporting frameworks have been developed, however there is no universally accepted framework that allows universal comparison of sustainability performance. In the absence of legislative prescription, organisations have been adopting these new disclosure frameworks on a voluntary basis only. One of the frameworks that is being adopted globally, as well as in Australia, is the GRI.

Because there is a variety of disclosure frameworks, and adoption of increased CSR disclosure is voluntary, there is very little consistency in organisational reporting and as such there is unreliability in disclosure, hence a need for further screening methods to better determine the sustainability performance of organisations. One set of screening methods available for large companies listed on global stock markets are the sustainability indices, and these are the focus of the next section.

SECTION 7: THE EMERGENCE OF CSR AND SUSTAINABILITY INDICES

The aim of this section is to examine sustainability performance indices and determine the extent of Australian representation within these global indices.

Section 7.1 outlines the emergence of nine major market indices designed to track the performance of a variety of listed companies that are seen to have desirable sustainability practices. These indices include: ARESE Sustainable Performance Indices; Dow Jones Sustainability Index; FTSE4Good Indices; Calavert, Domini Social Index; E. Capital Partners Ethical Index; Ethibel Sustainability Index; Humanix Ethical Index; and Jantzi Social Index.

Following a brief description of each of these indices, this paper catalogues each index according to: (a) their launch date; (b) the markets they cover; and (c) their Australian weighting. This section concludes by identifying that Australian listed companies are not well represented among these major indices.

7.1 The emergence of sustainability indices

In response to an increasing investor appetite for socially responsible and ethical investments (McKinsey & Company, 2000; Greene, 2003), and in an attempt to develop a performance rating for sustainability, a number of stock market indices have emerged on the global financial markets.

These sustainability indices are designed to benchmark the performance of global Socially Responsible Investments (SRI) and to help investors identify listed companies that employ sustainable business practices that incorporate a desire or practice to be socially responsible. These are companies that are focused on not just delivering sound financial performance but are equally focused on delivering performance around a number of sustainability issues.

Table 7.1 below lists the nine major stock market indices designed to track the performance of listed companies that are seen to have desirable sustainability practices. These indices will be examined in detail in the next section.

Index	Launched	Markets Covered	Australian Weighting
ARESE Sustainable Performance Indices	2001	Europe	-
Dow Jones Sustainability Index	1999	Global	2.63%
FTSE4Good Indices	2001	Global	1.46%
Calavert	2000	USA	-
Domini Social Index	1990	USA	-
E. Capital Partners Ethical Index	2000	Global	1.60%
Ethibel Sustainability Index	2002	Global	1.62%
Humanix Ethical Index	2001	Global	1.56%
Jantzi Social Index	2000	Canada	-

Table 7.1: Australian weightings of major sustainability indices (source: Hamid & Sandford, 2002)

7.2 The major sustainability indices

The nine major sustainability indices mentioned above are detailed in the following sub-section.

7.2.1 ARESE sustainable performance indices (ASPI)

The ARESE Sustainable Performance Indices (ASPI) was launched in July 2001 and track the financial performance of leading sustainability companies across Europe.

ASPI indices aim to offer consistent standards and definitions of SRI and sustainability, encourage dialogue and debate on these issues, promote the stakeholder agenda, encourage investment in companies that meet its criteria, and serve as the basis for investment funds, trackers and benchmarks for socially responsible investing.

The ASPI indices inclusion criteria has four main themes: (1) triple bottom line perspective; (2) positive screening approach; (3) risk management; and (4) a stakeholder-centered approach.

(1) Triple bottom line perspective - whereby social, environmental and financial performance are seen as equal and interdependent to the promotion of long-term shareholder value;

(2) Positive screening approach - where companies are selected for inclusion in the indices solely on the basis of positive screening - selecting companies adopting and moving towards good and best practice on sustainability issues;

(3) Risk management - companies are not excluded as a result of involvement in any specific activity;

(4) Stakeholder-centered approach - selected companies have to demonstrate a continuous commitment to the long-term interests of their stakeholders with their policy, strategy, behaviour and practice.

The ASPI does not include any Australian companies within its composite.

7.2.2 Dow Jones Sustainability Index

Launched in September 1999, the Dow Jones Sustainability Indices (DJSI) was the first global indices tracking the financial performance of leading sustainability-driven companies worldwide. The aim of the DJSI is to provide a benchmark for financial products and to measure the financial performance of companies that lead their industry in terms of sustainability. The DJSI attempts to identify the leading corporate sustainability practitioners worldwide.

In addition to the composite DJSI World Index, there are four specialised subset indexes excluding alcohol, gambling, tobacco, armaments and firearms. The DJSI also consists of a global and a European set of indexes.

The Dow Jones Sustainability World Index comprises the top 10% of companies in terms of economic, environmental and social criteria out of the biggest 2,500 companies in the Dow Jones Global Index.

The European indexes - the Dow Jones STOXX Sustainability Indexes comprise the top 20% of companies in the Dow Jones STOXX 600 Index that are seen as being best practice in terms of sustainability.

Dow Jones states that corporate sustainability is a business approach that creates long-term shareholder value by embracing opportunities and managing risks deriving from economic, environmental and social developments (Hamid & Sandford 2002).

The DJSI is constructed with a selection criteria comprising the following six elements: (1) strategy; (2) financial; (3) customer and product; (4) governance and stakeholder; (5) human; and (6) process.

(1) Strategy - integrating long-term economic, environmental and social aspects in an organisation's business strategies;

(2) Financial - meeting shareholder demands for sound financial returns, long-term economic growth, open communication and transparent financial accounting;

(3) Customer and product - fostering loyalty by investing in customer relationship management and product and service innovation;

(4) Governance and stakeholder - setting the highest standards of corporate governance and stakeholder engagement, including corporate codes of conduct and public reporting;

(5) Human - managing human resources to maintain workforce capabilities and employee satisfaction through best-in-class organisational learning and knowledge management practices;

(6) Process - developing and implementing risk management systems, and environmental management systems that encourage long-lasting social and environmental wellbeing in communities where companies operate.

Of the 316 companies included in the DJSI World Index, 16 are Australian companies, which represent a total of 2.63% of the total index market capitalisation. These Australian companies are illustrated in table 7.2 below:

Company	Market Sector	Marketcap Weightings
Amcor Ltd.	Industrial	0.08%
AMP Ltd.	Financial	0.09%
Australia & New Zealand Banking Group Ltd.	Financial	0.37%
BHP Billiton Ltd.	Basic Materials	0.52%
Brambles Industries Ltd.	Industrial	0.06%
Coles Myer Ltd.	Consumer, Cyclical	0.11%
Commonwealth Property Office Fund	Financial	0.02%
Investa Property Group	Financial	0.03%
Lend Lease Corp. Ltd.	Financial	0.04%
National Australia Bank Ltd.	Financial	0.53%
Rio Tinto Ltd.	Basic Materials	0.13%
TABCorp Holdings Ltd.	Consumer, Cyclical	0.05%
Wesfarmers Ltd.	Consumer, Cyclical	0.12%
Westpac Banking Corp.	Financial	0.34%
WMC Resources Ltd.	Basic Materials	0.07%
Woodside Petroleum Ltd.	Energy	0.08%

Table 7.2: Australian companies included in the DJSI World Index (source: www.sustainability-indexes.com)

Within the Dow Jones and STOXX classification, Australia's Westpac Banking Corporation is ranked as the world leader in the financial sector.

7.2.3 FTSE4Good Indices

The FTSE4Good Indices measure the performance of socially responsible companies around the world. Launched in July 2001, the selection criteria cover environmental sustainability, stakeholder relationships and universal human rights.

FTSE4Good aims to screen companies in a positive manner, recognising the attempts they make towards adopting corporate social responsibility practices.

The selection criteria for inclusion in the index has been drawn from analysis of globally recognised codes of conduct, such as the UN Global Compact and the Universal Declaration of Human Rights. FTSE4Good has identified common themes from 10 sets of principles in both governmental and non-governmental organisations (NGO's) or business organisations. These themes are used to create the selection criteria for the indices.

The 10 principles used are shown in table 7.3 below:

1	Universal Declaration of Human Rights (10 December, 1948)
2	The OECD Guidelines for Multinational Enterprises (1976)
3	The UN Global Compact (31 January, 1999)
4	CERES (Coalition for Environmentally Responsible Economies) (1989)
5	Amnesty International Human Rights Principles for Companies
6	The Caux Round Table Principles for Business (1994)
7	The Global Sullivan Principles (1977)
8	Ethical Trading Initiative - The Base Code (1998)
9	Social Accountability 8000 (SA 8000) (1997)
10	Global Reporting Initiative (GRI) Sustainability Guidelines (1999)

Table 7.3 10 principles used in FTSE4Good Index (source:www.ftse.com)

To create the indices, companies operating in excluded industries, for example tobacco producers or nuclear power stations, are firstly removed from the eligible universe. Next, the companies in the universe are then screened for environmental, social, stakeholder and human rights criteria. Companies are classified as either high, medium or low impact and have to meet a number of indicators for each of the above themes. The number to be met depends on their high, medium or low-impact classification, while indicators are split into both core and desirable categories. Companies that fulfil these criteria are eligible for the FTSE4Good indices.

Of the 627 companies that comprise the FTSE4Good Global Index, 17 companies are Australian. These companies are AMP, Australia & New Zealand Banking Group, Australian Gas Light, BHP Billiton Ltd, Bluescope Steel, CFS Gandel Retail Trust, Fosters Group, General Property Trust, National Australia Bank, News Corp, Origin Energy, QBE Insurance Group, Southcorp, Tabcorp Holdings, Telstra Corp, Westpac Banking Corp, and Woolworths. Together they represent only 1.46% of the indices weighting.

These Australian companies are seen as having world best practice in the areas of environmental sustainability, stakeholder relationships and universal human rights.

7.2.4 Calavert Social Index

Launched in April 2000, the Calvert Social Index measures the performance of US-based socially responsible companies included in the 1,000 largest companies (listed stocks on the NYSE and Nasdaq-AMEX) in the US.

Companies included in the Calvert index meet the selection criteria comprising environment, workplace issues, product safety and impact, community relations and investments, military weapons contracting, international operations and human rights, and indigenous peoples' rights.

Excluded companies include those that produce firearms, tobacco, alcohol, pornography, casino games and military weaponry.

The Calavert does not include any Australian companies within its composite.

7.2.5 Domini Social Index

The Domini Social Index is a socially and environmentally screened index consisting of primarily large-cap US companies and is the oldest US socially responsible index and was launched in 1990.

The Domini Social Index excludes companies with significant revenues from alcohol, tobacco, gambling, nuclear power and weapons contracting. It includes companies with positive records in community involvement, the environment, employee relations and hiring practices.

The Domini Social Index does not include any Australian companies within its composite.

7.2.6 E. Capital Partners Ethical Index

The E. Capital Partners Ethical Index was launched in January 2000 and is a global index based on criteria derived from the main UN Declarations on Human Rights, the fundamental International Labour Organisation (ILO) protocols, and from papers issued by scientific and religious institutes (such as the Vatican University) and NGOs dealing with human rights and environmental issues.

E.Capital combines the traditional financial approach with social and environmental criteria. It takes the view that a solid society is inherently connected to its relationships with the economic world (Hamid & Sandford 2002). The objective is to determine a company's contribution to sustainable development - a company with a positive assessment is eligible for index entry.

The general guiding principle of the index penalises those companies that operate in sectors E.Capital assesses as being injurious to the rights and dignity of humanity. Primarily, armaments, nuclear, alcohol, tobacco and gambling, and pornography. Companies that breach human rights and fundamental ILO protocols are also excluded.

The E.Capital includes only 1.60% of its weighting in Australian companies.

7.2.7 Ethibel Sustainability Index

The Ethibel Sustainability Index commenced in June 2002 and is a global index that focuses on sustainable development and stakeholder involvement.

Ethibel comprises companies that have been screened on the following core themes: internal social policy, environmental policy, external policy and economic-ethical policy.
The Ethibel includes only 1.62% of its weighting in Australian companies.

7.2.8 Humanix Ethical Index

The Humanix Ethical Index was established in January 2001 and is a globally focused index. Humanix comprises companies that have passed the Humanix ethical screening process and are approved by the Humanix Ethical Council for inclusion in the index.

Humanix includes only companies whose activities are not related to significant environmental risks, respect human rights, and where 97% or more of the total turnover is not derived from production and/or marketing of arms or the production of alcoholic beverages.

The Humanix Ethical Index includes only 1.56% of its weighting in Australian companies.

7.2.9 Jantzi Social Index

The Jantzi Social Index (JSI) is a socially screened index containing Canadian companies that pass a set of broadly based social and environmental criteria. The index was launched in January 2000.

The JSI does not include companies that have significant involvement in the production of nuclear power, the manufacture of tobacco products or weapons-related contracting. The JSI also avoids companies that have a consistently poor relationship with aboriginal communities; undertake questionable or fraudulent business practices; have a consistently poor employee relations record; have a consistently poor environmental performance record compared with industry counterparts; have experienced significant problems at their operations outside of Canada, or have operations in, or links with, Burma; or manufacture unsafe products.

The JSI does not include any Australian companies within its composite.

7.3 Catalogue of sustainability indices

Table 7.4 below catalogues the nine major stock market indices by both their Australian representation and their ratings criteria using four key elements of their criteria: (1) environmental impact; (2) corporate governance; (3) social impact; and (4) workplace practices.

Index	Australian Coverage	Environmental Impact	Corporate Governance	Social Impact	Workplace Practices
ARESE Sustainable Performance Indices	-	YES	-	YES	-
Dow Jones Sustainability Index	YES	YES	YES	YES	YES
FTSE4Good Indices	YES	YES	-	YES	YES
Calavert	-	YES	-	YES	YES
Domini Social Index	YES	YES	-	YES	YES
E. Capital Partners Ethical Index	YES	YES	-	YES	YES
Ethibel Sustainability Index	YES	YES	-	YES	-
Humanix Ethical Index	-	YES	-	YES	-
Jantzi Social Index	-	YES	-	YES	-

Table 7.4: Geographic reach and rating criteria of major sustainability indices

7.4 Summary of sustainability indices

Sustainability indices first emerged on a global basis in 1999 with the Dow Jones Sustainability Index (DJSI). While the methodologies used to compile the indices differ between each index, the focus of the selection models are similar in that they screen companies based on factors such as their corporate governance, workplace practices, social impact and environmental performance.

These indices have an important role in helping to facilitate SRI and to benchmark SRI performance (Mckinsey & Company, 2000). The out-performance of these indices (and the individual companies that together constitute the indices) relative to global stock market indices has also been used as evidence to support a growing argument that practicing sustainability increases the value of the firm (Bauer *et al*, 2003; Brown & Caylor, 2004, Grompers *et al*., 2003; Hamid & Sandford, 2002; Harrison & Freeman, 1999; Pava & Krausz, 1996; Roman *et al*., 1999; Waddock & Groves, 1997).

Of the nine major sustainability indices, only the Dow Jones Sustainability Index (DJSI) uses a comprehensive approach to CSR and rates its constituent companies using the four key elements of CSR: (1) environmental impact; (2) corporate governance; (3) social impact; and (4) workplace practices.

Of the nine major sustainability indices, only five have a global reach and of these five, only a few Australian companies are represented. The absence of stronger Australian representation across the indices and the absence of a comparable index on the Australian bourse indicate the relative immaturity of sustainability disclosure by Australian companies. This finding is consistent with a recent Federal Government study which examines corporate sustainability from the perspective of investors and concluded, "companies are not articulating their sustainability behaviours as well as they might" (Mays, 2003, p.6).

This lax behavior regarding sustainability disclosure by the majority of Australian listed companies is likely to change with the pressure coming from: (a) an increase in Australian SRI investment; (b) new legislation targeting disclosure; and (c) the introduction of a ratings agency focused on this rating typology. These changes will be examined in the next section.

SECTION 8: CONCLUSIONS AND SUMMARY

The aim of this section is to examine the contemporary Australian situation concerning sustainability rating and reporting and provide a conclusion to this paper.

As the paper observed in the previous section, there are few sustainability indices that cover the Australian stock market, and of those indices, few Australian companies are represented. The following sub-sections will discuss the contemporary Australian practices for social reporting and disclosure. Section 8.1 will discuss the lack of an Australian SRI stock market index. Section 8.2 will discuss the extent of sustainability disclosure in Australia. Section 8.3 will discuss the contextual factors affecting legislation that may influence Australian sustainability reporting. Section 8.4 will discuss the factors affecting the demand for sustainability reporting in Australia and, section 8.5 will provide a summary of the Australian situation. Finally, section 8.6 will conclude with the findings of this paper.

8.1 Lack of an Australian SRI investment index

Only a few Australian companies are represented on the major sustainability stock market indices, as this paper outlined in section 7.4. This lack of representation makes it difficult to benchmark the performance of socially responsible investment (SRI) in Australia, which is an increasingly preferred investment style (McKinsey & Company, 2000). The lack of representation of Australian companies in the indices also makes it difficult for the growing number of SRI and ethical investment funds (Greene, 2003) to identify suitable Australian companies for investment.

Highlighting the relative immaturity of Australian sustainability disclosure and reporting among Australian companies (Mays, 2003), the Australian Stock Exchange (ASX) has not issued any guidelines for disclosure by its members. Nor has it yet to construct an all-Australian index to benchmark domestic SRI or ethical investment, despite the growth in funds under management of Australian equities directed into this investment style.

8.2 Extent of sustainability disclosure in Australia

Australian companies are relatively immature in their reporting and disclosure of sustainability, as established in section 7. Ramsay in 2001 produced a public indictment of Australia's reporting and disclosure framework as generally having fallen behind world's best practice (Dwyer & Laura, 2002, p. 634).

The absence of public standards in Australia on sustainability among Australian companies has meant a lack of meaningful voluntary disclosure, despite the literature suggesting there may be an economic benefit for those companies who choose such disclosure. As at March 2004, only 22 Australian organisations have adopted GRI reporting (source: www.globalreporting.org), the majority listed on the ASX and operating in the mining and utilities sector.

However, new legislation targeted at the managed investment industry will focus listed companies to disclose their sustainability performance in order to attract and retain institutional investment support from those growing number of fund managers operating SRI or ethical funds.

8.3 Some contextual factors in Australian SRI

In Australia, the recent *Financial Services Reform Act (2001)* requires all issuers of investment products, typically managed investments (managed funds), annuities and superannuation funds to disclose the extent to which labour standards or environmental, social or ethical considerations are taken into account in the selection, retention or realisation of an investment. With greater investor interest being channelled into managed investments (Greene, 2003), such as ethical funds or Socially Responsible Investments (SRI), the intent of the law is to place pressure on companies to increase their level of disclosure about their social and environmental policies and practices (Uren, 2003, p. 156).

This legislation is not intended to target listed companies and disclosure to their direct share investors, but rather to the fast-growing indirect managed investment market, with investors subscribing to units in managed funds or investment products.

The *Financial Service Reform Act* broadly segregates investment products issued in the Australian investment market into three camps. First, there are those product issuers who never consider either environmental, social and ethical considerations, or labour standards in the selection, retention or realisation of an investment. Investment products such as cash management trusts and hedge funds typically fall into this camp.

Second are the majority of product issuers who do not normally screen investments on the criteria covered by the legislation, but who will consider them on an ad-hoc basis to the extent that they will have a direct effect on the valuation of the investment.

These product issuers adopt a pro-forma disclosure that meets the requirements of the legislation.

Third, there are the funds with an explicit emphasis on social responsibility. Greene (2003) showed that ‘screened’ funds, those that explicitly incorporate an ethical component in their investment decisions, are the fastest growing portion of the investment market with a total of $10.5 billion under management. The legislation calls on these product issuers to explain the criteria they use.

A possible outcome of the *Financial Service Reform Act* is that every time investors select a managed fund, they are reminded that it is possible for them to choose an SRI or ethical investment fund. This will create a demand from listed companies to compete for this growing pool of investment capital. Proposed legislation allowing investors to choose their superannuation investments is expected to give the ‘screened’ funds an even greater inflow of funds, making this pool of capital more attractive to Australian companies.

With significant growth in this sector of the market, SRI and ethical investment is becoming more organised (e.g., establishment of international benchmarks such as DJSI) and many major product issuers, including AMP and Westpac, are developing investment products and marketing them strongly (Uren, 2003, pp. 156-157).

As the SRI market becomes more organised and developed, this will increase the demand for sustainability reporting from Australian companies.

8.4 Demand for social reporting in Australian companies

With a change in attitude from investors who are seeking SRI and ethical investment, and new legislation designed to encourage sustainability disclosure in investment products, the demand for social reporting in Australia is increasing.

This increased demand, plus new legislative requirements, may force more companies to change their behaviour, and adopt a more comprehensive and transparent social reporting framework, such as the GRI.

The arrival of sustainability ratings, such as those currently provided by RepuTex, may also influence Australian companies to the extent that they will manage their operations and disclosures in ways that satisfy the rater’s criteria, as Dillenburg *et al*. (2003) had concluded with financial ratings and corporate behaviour.

8.5 Summary of Australian situation

A number of key factors are influencing the demand for sustainability disclosure in Australia’s relatively immature market. These factors include: (a) the small number of Australian companies represented on global sustainability indices; (b) an increase in the number of Australian domiciled investment funds with an SRI or ethical mandate (Greene, 2003); (c) an increase in the size of Australia’s funds under management with an SRI or ethical mandate (Greene, 2003), and (d) reforms to Australian financial services legislation that are requiring disclosure of sustainability metrics. In meeting this demand, RepuTex has introduced social responsibility ratings that may have an impact on Australian companies' stakeholder disclosure and their corporate behaviour.

<u>8.6 Conclusions for this paper</u>

In summary, this paper has identified three generalist international rating agencies that provide ratings of multiple types. Also, it identified the other main international rating agencies that specialise in only one rating type.

In the examination of rating types, it was noted that one of the typologies, sustainability, was not well represented. In fact only one international rating agency includes sustainability in its rating criteria.

Also, the paper developed an independence framework to understand the various rating methodologies. From this, it was determined that the co-operative method was superior to either the solicited or unsolicited methods. This framework was underpinned by the audit independence literature.

In terms of the second objective, which was to explore the sustainability performance as determined by extended reporting frameworks and coverage by international rating agencies and market indices, it was found that very few Australian organisations were covered by either the RepuTex rating or the global indices. Also, the extended performance reporting frameworks appeared to have had little impact on Australia.

In conclusion, the influence of international rating agencies on financial ratings and their impact on corporate behaviour is well documented, however, as has been established above, there is only one international rating agency which is providing a sustainability performance rating. At present, this rating encompasses only the top 100 organisations throughout Australian and New Zealand.

There are many avenues for further research, including the desire to understand the impact of sustainability performance ratings on corporate behaviour and on stakeholder decision making.

On the public policy front, there are a number of issues, such as whether the ASX should introduce an all-Australian sustainability index. Such a move may motivate more listed companies to adopt social reporting to facilitate inclusion within the composite. Although such an index would be: (a) useful to track the performance of aggregate domestic investment; and (b) provide a screening mechanism to identify listed companies with expert disclosure, it would not provide any assessment of individual company's ranking – for this is the role of a rating agency.

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