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The Ethical Ratings Phenomenon: Towards a Research Agenda

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The Ethical Ratings Phenomenon: Towards a Research Agenda

The contemporary business environment exhibits an increasing number of examples of agencies which produce ratings of non-financial aspects of company behaviour – many of which are directly concerned with, or relevant to, ethical issues in business. The primary aim of this paper is to initiate a debate in business ethics about the ‘ratings phenomenon’. Thus it seeks to promote recognition by scholars of rating agencies as significant players in the business environment; to stimulate serious analysis of those agencies; and to begin construction of an agenda for empirical research and reflection on their activities.

The paper is structured as follows. First, as a position paper written at the commencement of an empirical research project, it develops a framework for thinking about rating agencies as information intermediaries which provide a service to various parties interested in the ethics of companies. The second section illustrates some of the different forms such agencies may take by providing brief descriptions of three examples currently operating in the UK. Deriving from the framework, an extensive list of research questions relating to the three major categories of players involved – companies, rating agencies and users of the ratings generated – is then presented.

An Informational Perspective on the Ratings Phenomenon

The rise of interest in the ethics of business and corporate social (ir)responsibility has brought with it a demand for information about companies. This has prompted calls for corporate social reports (or similar), which has brought forth a constructive response from some companies. In the absence of widespread, consistent and reliable corporate social reports, though, the various parties seeking to understand the behaviour of companies in social/ethical terms have to rely upon other sources of information to provide the kind of assessment and analysis they seek.

However, the appropriate information is costly to obtain and process, often requiring considerable investment and expertise to exploit to its full potential. Normal annual reports, which are readily available and contain much more than just the financial accounts, might be a ‘useful starting point’ (Griffith, 1992, p. 260) and even in their
current state can be used to construct a ‘silent account’ by assembling all the socially- or ethically-relevant elements (Gray, 1997). However, any analysis based solely on corporate annual reports will be partial and incomplete for all but the most limited of purposes. Depending on the interests and concerns of the particular party, the potential sources of data to be used are many and varied. They might include press releases, court and tribunal reports, product packaging, newspaper articles, brochures and advertising, and reports by lobby groups. The data can be difficult to obtain, incomplete and, perhaps, difficult to interpret or of dubious reliability. Interested parties will thus have to make decisions, not only about their primary concern (e.g. what to purchase or where to invest to reflect their ethical values), but also about the best way to manage the information on which they will base their decisions. This includes the possibility of out-sourcing all or part of the information management function to some third party. As Powers wrote in the early days of the movement which saw ethical or socially responsible investment become widespread in the USA, ‘There is simply a crying need for information and for organizations to research and compile such information’ (Powers, 1971, p. 170, emphasis in original).

The information required by various parties interested in the ethics of businesses will depend on a number of interrelated factors, including their particular concerns, the ethical values from which those concerns derive, the nature of the decisions they might be making, their existing state of knowledge and understanding, and their ability to process information. Their requirements are thus heterogeneous and suggest the prospect of many different analyses of companies taking place.

However, although the precise needs of various parties will differ, there is likely to be some commonality or overlap in the needs of many of them. This provides the potential to establish ‘information intermediaries’ (Moizer & Arnold, 1984) which can provide appropriate services, bridging the information gap between companies and various parties interested in their behaviour. The services provided might not fully meet the needs of an individual decision-maker, but they might be good enough, given the costs and other challenges involved; and decision-makers can also undertake complementary analyses for themselves if they deem it necessary. Moreover, it is not always the case that decision-makers have a fully articulated position on what information they need. Their concerns can sometimes be incipient or rather general, in which case the availability of particular items of information can
serve to frame the way they interpret or give expression to their concerns. Such possibilities increase the likelihood that information intermediaries, in the form of rating agencies, will come to colonize the space between parties concerned about business ethics and the companies about which they desire to be informed.

The principal activity of an information intermediary can be viewed as an input-output process, turning data into information useful for end users. The input is the data on which it is going to base its rating or similar assessment. The rating agency could gather existing data, which could be either quantitative or qualitative. Much of this will be focused on specific topics or issues. Some will have been disclosed by the company, whether on a voluntary basis or in compliance with some regulatory requirement. Useful data published by another party might also be available. This might have been intentionally produced with a view to ethical critique or evaluation of the company concerned, such as in the case of a campaigning group publishing a report on the activities of a petro-chemical company in a particular region. Alternatively, the data might have been produced for another purpose but might still be of relevance in an ethical assessment. The information intermediary could also generate original data, perhaps by surveying the companies of interest by means of a questionnaire. Then the various items of data will be processed in various ways. For example, they could be filtered for quality, adjusted for comparability and then brought together in some way, perhaps as a letter grade. Finally, the processed data will be made available to users of the information intermediation service. This process is summarized in Figure 1.

Insert Figure 1 here

Rating Agencies: Three Examples

Having identified ethical rating as a phenomenon of interest and having outlined a basic view of rating agencies as information intermediaries, it is appropriate to illustrate the somewhat general or abstract points made so far by presenting some specific examples. All are from the UK, because that is where the authors are based and it is where the first phase of empirical research is planned to take place. The ‘case studies’ are not intended to form a comprehensive set, nor are they presented as examples of either good or bad practice. Based solely on limited secondary sources at
this stage, their role is, in the context of this paper, to ‘flesh out’ the skeletal framework (Laughlin, 1995) presented in the previous section and to pave the way for the presentation of a list of research questions. The three examples are FTSE4Good, the Business in the Community Index and EIRIS.

**FTSE4Good**

Launched in 2000, FTSE4Good is a family of stock market benchmark and tradable financial indexes. FTSE4Good indices have been designed to measure the performance of companies that meet globally recognized corporate responsibility standards, and to facilitate investment in those companies.

To be eligible first requires that companies are already included in one of the core FTSE Indexes. Automatically excluded from the FTSE4Good index are companies which operate in the tobacco industry or in certain parts of the defence and nuclear industries. Companies are assessed on three dimensions:

- Environmental sustainability, e.g. carbon dioxide emissions
- Stakeholder relationships, e.g. equal opportunities policies
- Human rights, e.g. International Labour Organization labour standards

A distinction is made between three levels of company response:

- Policy – broad strategic aims to guide behaviour on responsibility criteria
- Management systems – processes and structures to implement policy at operating level
- Reporting – communicating progress and understanding through independently verified reports

The emphasis on assessing companies is due to change over time from this predominantly procedural focus to one concentrating on substantive performance through measurable outputs. Various data collection mechanisms are used including direct contact with companies and secondary trawls of annual reports and company websites. In addition EIRIS is used (see below).

It is interesting to note that the stringency of criteria can vary based on which industry sector a particular company operates in. For example, an oil company is
automatically categorized as having a high environmental impact regardless of the scale of its operations. In contrast a telecoms company is categorized as low impact. This then translates into variations in what each company is required to demonstrate. For example, the telecoms company, unlike the oil company, currently does not have to produce an environmental report to qualify for inclusion in the index.

The index resembles an ethical investment fund (Cowton, 1999) in the sense that companies are either in or out. The difference is that, with an ethical investment fund, a company might not be included in the portfolio on financial rather than ethical grounds and so nothing should be inferred about the ethics of a missing company unless an explicit explanation for its exclusion has been issued. In the case of the FTSE4Good index, though, all companies within the defined universe are assessed and so non-inclusion in the index implies some sort of failure against the stated ethical criteria, while membership implies an adequate degree of acceptability. Thus in its basic form the FTSE4Good index, as an ethical rating, is binary in form; a company either qualifies for the index or it does not.

**BiTC Corporate Responsibility Index**

The Corporate Responsibility Index initiative was begun by Business in the Community (BiTC) in 2002 as a response to the perceived need for an authoritative, publicly available ranking of companies on CSR criteria.

Companies have to offer themselves to be included. They complete questionnaires and are then ranked against other companies across a basket of criteria. Four relate to management practice on:

- Community
- Environment
- Marketplace
- Workplace

The fifth rating measures the extent to which Corporate Responsibility has been integrated into corporate strategy. Under each of these five headings a company

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receives a grade of A, B or C. A indicates that companies are measuring and reporting their progress in this area, while B indicates it is moving beyond a basic commitment. C indicates the first stirrings of a company response on these issues. The resulting profiles are made publicly available. Companies are also ranked using the underlying scores and divided into quintiles. These quintiles are published but the companies within each quintile are listed alphabetically. Thus the rankings are turned into classifications for the purposes of publication.

Confidential, detailed feedback is offered to participants in the Index. It is designed to aid further progress by highlighting key areas in need of attention.

**Ethical Investment Research Service (EIRIS)**

EIRIS is a charity which was set up in 1983 with the help of a group of voluntary organizations which wished to address ethical issues in their investment decisions. EIRIS Services Ltd, a subsidiary company of EIRIS, undertakes most of the research for investor clients. EIRIS’s first major client was Friends Provident’s Stewardship Trust, which is still the leading retail ethical investment product in the UK. Indeed, the establishment of the two was closely linked. EIRIS now supplies information for most of the ethical investment products available in the UK and for leading financial institutions, such as Goldman Sachs and AXA Sun Life. Clients also come from the government sector, pension funds, and high profile charities. EIRIS supplies information for FTSE4Good (see above).

EIRIS works collaboratively with other bodies to promote and publicize the concept of ethical or socially responsible investment, but it is very clear that it does not promote one particular view on ethical issues. Thus it does not formally rank companies or provide summary score for them. Instead, it is left to clients to specify their concerns. EIRIS’s database of companies is then used accordingly.

For example, EIRIS can provide a tailored list of companies that do not breach negative criteria chosen by a client, i.e. those activities that the client considers "unacceptable". Companies covered are UK companies in the FTSE All-Share Index (excluding Investment Trusts) and companies in the published UK portfolios of ethical funds. The client selects the negative criteria by completing a questionnaire which relates to the data stored on the EIRIS database. EIRIS can also supply a
Company Report, which provides a profile of a particular company, showing how it performs against social and environmental benchmarks that EIRIS researches. Another service is a donor screening service, which enables charities to choose corporate donors that either positively reflect their values or do not participate in activities which conflict with their aims. Amongst other services provided is the Business Briefing Service, which is available to all UK companies researched by EIRIS. The service is primarily for investor relations and corporate affairs personnel who want to be informed of developments in the ethical investment world and how investors’ social and environmental concerns affect their company. For example, a quarterly sector report shows how one company’s status compares with its competitors on a wide range of social and environmental indicators; and the annual criteria usage report shows how many investors use the various EIRIS research criteria as part of their investment decision-making process.

In collaboration with partners overseas, EIRIS researches over 2500 companies, including all companies on the FTSE All-Share Index, the European companies of the FTSE All World Developed Index and a number of others. Each company is analyzed against 350 environmental and social indicators in more than forty different areas, with regular reviews of each in order that the latest developments in the field are taken into account. The issues researched include the following:

- Environmental issues – e.g. environmental management, policy, and reporting; tropical hardwood; water pollution
- Stakeholder issues – e.g. community involvement; equal opportunities; trade unions and employee participation

Other issues include animal testing, human rights, and military production and sale. Historically, information on companies’ involvement in South Africa under Apartheid was a major focus of activity.

EIRIS gathers and analyzes information from sources such as government and regulatory agencies, industry organizations, trade publications, campaigning bodies, academic reports, and the output of other research bodies. In addition, it gathers information from the companies themselves, using questionnaires and the data in companies own reports and accounts, and other regular communications sent to shareholders. EIRIS sends companies full reports detailing the data held on them
approximately every 18 months, thus giving companies the opportunity to corroborate or correct the information stored on the database.

In conclusion, EIRIS might not be seen as a rating agency since it does not attempt to provide summary scores for companies. Instead, it provides clients with the information they need to put their own principles into practice, subject to the shifting constraints – in relation to companies and issues covered – of its database. However, it does provide assessments of many social, ethical and environmental attributes of companies. And it is important to understanding the ratings phenomenon, particularly in a UK context: first, in the practical sense that its links with other agencies influence what they choose and are able to do; and second, in the more theoretical sense that the approach it takes helps to put other approaches into perspective.

**Exploring the Ratings Phenomenon**

One of the functions of the empirical phase of the research will be to develop fuller descriptions and deeper analyses of several rating agencies, including those briefly described above. Elements of what they do will be tabulated on certain dimensions reflected in the questions outlined below. During the research phase the intention is to explore not only what rating agencies say about themselves but also the associated attitudes and behaviours of companies and users. It is intended that the research will gather both primary and secondary data, first on the raters themselves, and then on companies and users of the ratings. Interviews are likely to be a major component of the research endeavour.

Building on the framework developed earlier, an initial list of questions has been developed to guide the research work. They are divided into three categories according to the ‘players’ identified in Figure 1. It is expected that in the collection of primary data, each class of player will be asked about their perceptions of the other players as well as themselves.

**Rating Agencies**

What are they rating? Which issues or dimensions are addressed? How comprehensive or focused is the output (or outputs) of the rating process?
What sort of ratings do they provide? For example, are they continuous scale (e.g. 1 to 5, with any rational number possible), grading system (e.g. A, B or C), ranking, or binary classification (e.g. acceptable versus unacceptable)?

Are the ratings aggregated into a single summary score or are they (also) available in detail? If so, is there a difference in availability of the different levels of detail, such as the more highly summarized ratings being made public available while the underlying details are available only to the individual company being rated?

What do they claim for their ratings? Do they make any statements about assumptions, statistical error or tolerances? How clear is it to a user how a particular company has come to obtain a particular rating?

What is the population of companies being rated? How is it defined, e.g. geographically, by size, whether listed on a stock market or not? Are all companies within a defined population covered, or only those which are willing to be part of the process?

What data sources are used? What challenges do the agencies face in obtaining and processing data? What developments would they like to see take place, e.g. would they like to see corporate social reporting become more widespread, perhaps supported by legislation? If so, what sort of standards would they like to see? To what extent do they use mechanical, transparent process and to what extent is judgement involved?

How often are the ratings calculated? If they are up-dated, what triggers that – passage of time, publication of annual report, or some particular event?

How do they publish their output, e.g. hard copy, on-line? How is it distributed, e.g. public access, subscription only?

Why was the rating process established? What is the aim of producing the ratings? What impact is it hoped will be achieved?

What led them to take the approach they have adopted? How might it develop in the future? Do they have any input from ‘ethics experts’?

How do they compare themselves with other rating agencies? What are their respective strengths and weaknesses? To what extent are they competitors (e.g. the BiTC seeks to be ‘authoritative’)? Are there formal or informal links between them?
How is the rating process funded? Has its funding basis changed over time?

**Users**

Who are the principal users of ratings, e.g. investors, companies, media, government, researchers? How much interest do journalists show in them?

What are they interested in? How have their interests changed over time, and in what directions are they currently developing?

Which ratings do they use and how do they use them? What do they use them for? Are they ‘end users’ or do they use the ratings to provide a service to other parties?

Do they re-work the ratings; if so, why? Do they use multiple ratings; if so, how do they relate them to one another?

How satisfied are they with the rating processes? Are their wants/needs met?

Where are the shortcomings, e.g. relevance, reliability, coverage of issues, coverage of companies? How would they like to see ratings develop?

**Companies**

How aware are they of different rating processes and their standing against them?

What do they think of the different rating processes? Do they participate in providing information to the rating agency; if so, how is that managed?

Have they ever sought to have a rating changed; if so, with what success? Do they view the rating agencies as ‘ethical’?

Have they considered changing their behaviour (including information disclosure) in response to a rating?

What is the nature of their relationship with the raters, e.g. co-operative, neutral, adversarial, ignorant?

Do they monitor ratings of rival companies?

Do they publicize their own ratings?
Conclusion

The questions listed in the previous section are only an initial set. The list is unlikely to be exhaustive at this stage, but it is hoped that it succeeds in highlighting many of the major issues which could usefully be addressed by means of empirical research. It is likely that other questions will be added by the time the research begins, and indeed as the project evolves, with novel comments from one interviewee feeding into later interviews.

It should be noted that the focus in the paper upon empirical research is not intended to imply that other sorts of scholarship will not be of value in improving our understanding of attempts to rate companies in ethical terms. However, it is contended that for constructively critical and appropriate reflections to be developed, substantive knowledge of what rating agencies actually do and an awareness of companies’ and users’ involvement and responses are vital. It might be tempting for academics to be dismissive of the ability of rating agencies to measure the ethics or social responsibility of companies, but ratings are a feature of the modern business environment and are unlikely to disappear. Furthermore, any judgement on companies tends to involve quantitative or similar processes, with various aspects of corporate behaviour being assessed and weighed; at least ratings agencies are – potentially – relatively disciplined and transparent about the process of doing this. We would contend that it is therefore sensible to seek to understand the ethical ratings phenomenon and, based on that understanding, to seek to improve both the conduct of the rating process and the usage of its outputs.

The principal aim of this paper has been to raise awareness of the ratings phenomenon and initiate debate about it. As the empirical research to which the paper points forward progresses, it is hoped that the findings will not only be useful to the various players involved but also make significant contributions to the academic fields of business ethics and social accounting, for which it would seem to hold considerable relevance.
References


Figure 1: Rating agencies as information intermediaries