

Assessing corporate sustainability through ratings: challenges and their causes

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Abstract

Assessing corporate sustainability is increasingly practice-relevant. Since the capital market has been paying growing attention to the topic, ratings have become an important assessment approach. Nowadays, a variety of rating organizations and financial service providers conduct their own ratings. Yet, despite their growing popularity, ratings are criticized in research and practice. Thus, the purpose of this paper is to display the challenges that corporate sustainability ratings face: standardization, transparency, bias, weighting tradeoffs, credibility of information, and independence. Furthermore, the paper discusses the causes of these challenges and identifies none of them as exclusively rating-specific. Thereupon, the paper argues that ratings are a suitable approach to assess corporate sustainability, but that certain steps have to be taken in order to increase their reliability.

Keywords: corporate sustainability measurement, corporate sustainability assessment, ratings, socially responsible investment (SRI)

1. Introduction

Sustainability is a topic of growing significance for companies (Epstein, 2008; Dunphy et al., 2003; Dyllick & Hockerts, 2002) just like the contribution of companies is becoming essential for sustainable development (Schaltegger & Burritt, 2005). Increasingly, the demand for corporate sustainability (CS) is not only driven by societal or political expectations ('push factors') but also by the potential for internal organizational improvements (e. g. cost reduction) as well as the demand of consumers and investors ('pull factors') (Schaltegger et al., 2010; Schaltegger & Wagner, 2006; Meffert & Kirchgeorg, 1998; Dyllick et al., 1997). Examples of this latter market pull are the rising demand for organic food (Wier & Calverley, 2002) and the growing significance of socially responsible investment (SRI) (Beloe et al., 2004; Sparkes & Cowton, 2004; Schaltegger & Figge, 2001; Moskowitz, 1997).

This increasing market demand entails the need for CS assessment. Since the corresponding information in individual companies is rarely publicly available, there is a substantial risk that sustainability-oriented companies are not recognized as such. If consumers and investors make their purchase and investment decisions based on CS but only have incomplete information, sustainability-oriented companies may in the worst case be crowded out of the market, although they actually offer what customers are looking for. In order to prevent such a 'market for lemons' (Akerlof, 1970) information intermediaries with more resources to gather information become important, for example consumer associations, NGOs, and journalists (Chatterji & Toffel, 2010; Rischkowsky & Döring, 2008; Lee & Cho, 2005; Healy & Palepu, 2001).

Because of the increasing interest of the capital market, *ratings* have become especially important for CS assessment (Chatterji & Toffel, 2010; Schäfer et al., 2006). In the capital market, ratings are an established tool to estimate the credit worthiness of companies (Healy & Palepu, 2001). However, despite (or perhaps because of) their increasing relevance, CS ratings are subject to a lot of criticism (e. g. Delmas & Blass, 2010; Hansen, 2010; Chatterji et al., 2009; Fowler & Hope, 2007, Chatterji & Levine, 2006; Schäfer et al., 2006; Beloe et al., 2004; Graafland et al., 2004; Dillenburg et al., 2003, Figge & Schaltegger, 2000). The fact that ratings try to fulfill an ambitious and challenging task is revealed by their missing standardization and the lack of best practice methods. Important reasons for this are the missing definition and the subsequent diverse perception of CS (Linnenluecke et al., 2009; Schaltegger & Burritt, 2005; Seelos, 2004). This room for interpretation has not only led to a range of CS practices (e. g. philanthropic sponsoring activities, the application of

environmental management systems, or core business relevant sustainability management), but also to heterogeneity of assessment approaches – not only of ratings and SRI research but of CS assessment approaches in general (Delmas & Blass, 2010; Schäfer et al., 2006; Schaltegger & Figge, 2001). Table 1 offers a brief overview and lists some examples.

CS assessment approach	Examples
SRI research ('inhouse')	Sarasin's Corporate Sustainability Rating (Bank Sarasin & Cie AG, 2007) ZKB Sustainability Research (ZKB, 2011)
Ratings ('independent')	KLD Environmental, Social and Governance (ESG) Ratings (KLD Research & Analytics, Inc., 2011) oekom's Corporate Responsibility Rating (oekom research, 2011a)
Indices	Dow Jones Sustainability Indexes (DJSI) (based on SAM's Corporate Sustainability Assessment and Dow Jones Indexes) (SAM Group, 2010; SAM Indexes, 2010; SAM & PwC, 2010) FTSE4Good (based on EIRiS sustainability research and Financial Times Stock Exchange Group) (The EIRIS Foundation and Ethical Investment Research Services, 2009) Ethibel Sustainability Indices (ESI) (based on Vigeo's sustainability research and Standard and Poor's) (Vigeo & Forum Ethibel, 2007)
Rankings	Good Company Ranking (Balzer et al. 2009) Global 100 Most Sustainable Companies in the World (Corporate Knights Inc., 2011)
Awards	German Sustainability Award (Stiftung Deutscher Nachhaltigkeitspreis e.V., 2011)
Research by NGOs, consultants, and research organizations	Guide to Greener Electronics (Greenpeace, 2010) Carbon Disclosure Project (Carbon Disclosure Project, 2009)

Table 1: Overview of prevalent external approaches to assess CS

This variety of approaches actually poses a problem in its own right, because consumers, investors, and further stakeholders are increasingly confronted with the "confusing multitude" of assessments (Wier & Calverley 2002, p. 54). The organic food sector, for instance, has generated a variety of certificates and labels. Therefore, it is difficult for consumers to decide which labels to trust and how to compare products using competing labels (Jahn et al., 2005; Wier & Calverley, 2002). Accordingly, stakeholders are still unable to judge whether a company is really oriented towards sustainability and, thus, depend on the assessment of intermediaries (Rischkowsky & Döring, 2008).

Against this background, the research question of this paper is what challenges CS ratings face and what their causes are. In order to answer this question, the paper is structured as follows. Firstly, it displays the challenges for CS ratings based on a literature review. A number of ratings are included for illustration purposes. Secondly, the paper determines the

causes of these challenges and analyzes whether they apply to other assessment approaches, too. Thereupon, the paper discusses whether these challenges are truly rating-specific. It also argues whether ratings are a suitable approach to assess CS reliably and, if not, what it takes to get there.

2. Background: Relevance of ratings in theory and practice

This chapter elaborates on the relevance of external CS assessment ('screening') from a theoretical perspective, and then highlights the practical importance of ratings in particular.

2.1 Relevance of external CS assessment ('screening')

An important difficulty when assessing CS externally lies in *information asymmetries* (Rischkowsky & Döring, 2008; Lyon & Maxwell, 2006; Schaltegger, 1997). Consumers, investors, and other stakeholders are not able to verify the sustainability claims or promises made by companies, because they do not have access to the relevant information. This not only affects products whose sustainability characteristics are difficult to grasp for stakeholders (see Jahn et al., 2005 for a discussion of search, experience, credence, and Potemkin goods), but also processes inside companies and along their supply chains (Epstein, 2008; Chatterji & Levine, 2006). Third party institutions with more resources to gather the information needed become important players (Rischkowsky & Döring, 2008; Lee & Cho, 2005; Healy & Palepu, 2001). Rating organizations are one example of such information intermediaries.

Another important aspect is that CS is socially desired (Epstein, 2008; de Boer, 2003). Ongoing discussions in the media as well as the increasing meaning of sustainability-oriented products, for example in financial markets, illustrate that society and markets are increasingly aware of and concerned with the topic (Schaltegger et al., 2010; Hansen et al., 2009; Sparkes & Cowton, 2004; Wier & Calverley, 2002; Meffert & Kirchgeorg, 1998). This fact may not only motivate companies to get involved with sustainability issues and to communicate about them with stakeholders but also to exclusively communicate positive and leave out negative information. In an extreme case, companies may even perceive an incentive to pass on false information in order to improve their reputation or market share (Rischkowsky & Döring, 2008; Schaltegger et al., 2003; Darby & Karni, 1973). The risk of this opportunistic behavior is increased by the lack of a common definition of CS and the large scope of different interpretations.

The outcome of such a situation may be a 'market for (organic) lemons' in which stakeholders cannot identify sustainability-oriented companies (hidden characteristics), which, in return,

leads to a diminished willingness to pay for the companies' products or a lower readiness to invest. Ultimately, sustainability-oriented companies may be crowded out of the market (adverse selection) (Rischkowsky & Döring, 2008; Akerlof, 1970). This market failure may cause negative effects for the environment and society when sustainability-oriented companies and products are replaced by conventional, primarily economically-oriented ones (Schaltegger et al., 2003). Accordingly, the contribution of companies to sustainable development of the economy and society will diminish even more.

Both Economics of Information (e. g. Stiglitz, 2000; Shapiro, 1982; Stigler, 1961) as well as the principal-agent theory (Jensen & Meckling, 1976) (and related newer approaches like the stakeholder-agency theory; Hill & Jones, 1992) deal with ways to overcome asymmetric information or adverse selection in markets. They offer two basic approaches to this problem. The first approach is *signaling* (Spence, 1973). Signaling in this context means that companies emit credible signals indicating their sustainability orientation. Examples are the publication of sustainability reports, the establishment of brands, and the use of labels (without external verification) (Finch, 2004; Kolk, 2004; de Boer, 2003). However, these signals only fulfill their function if the addressees perceive them as reliable (Rischkowsky & Döring, 2008; Müller, 2006). Yet, reliability is not always given due to the "climate of general distrust towards social organizations" (Renn & Levine, 1991, p. 212) and the risk of opportunistic behavior described before. Therefore, signaling may be insufficient in the context of CS.

An alternative approach to overcome information asymmetries is *screening*, which here means that consumers, investors, or other stakeholders actively search for and evaluate information on the sustainability performance of companies (Rischkowsky & Döring, 2008; Stiglitz 1975). Compared to earlier times, the Internet allows for much more transparency and information access (Rezabakhsh et al., 2006; Seelos, 2004). Yet, consumers and investors cannot access all relevant data as a matter of resource constraints (time and data access). Hence, information intermediaries come into play (Rischkowsky & Döring, 2008; Lee & Cho, 2005; Healy & Palepu, 2001). Ratings are an important example of this kind of external assessment. Two major problems complicate screening for CS: firstly the diverse perception of the concept and secondly the information asymmetry described above. Yet, although several challenges have to be met in order to reliably assess CS by screening, it still appears more promising than signaling which makes opportunistic behavior easier (Graafland et al., 2004). Furthermore, screening simplifies the comparison of different companies which could

be relevant to consumers and investors. Therefore, this paper focuses on ratings as a practice-relevant application of screening.

Nonetheless, when differentiating between signaling and screening it has to be kept in mind that one approach cannot be seen separate from the other. On the one hand, the assessment made through screening like ratings can be used to substantiate companies' signaling approaches, which might be perceived as more reliable than information without external verification (Rischkowsky & Döring 2008). Audits, labels, and certificates also follow this procedure. On the other hand, in order to carry out their assessment, ratings depend on the disclosure of information by companies and, thus, on suitable internal metrics (Chatterji & Levine, 2006). For these reasons, CS signaling and screening are interdependent. As figure 1 shows, intermediaries step in to carry out the screening process for stakeholders and to substantiate companies' signals.

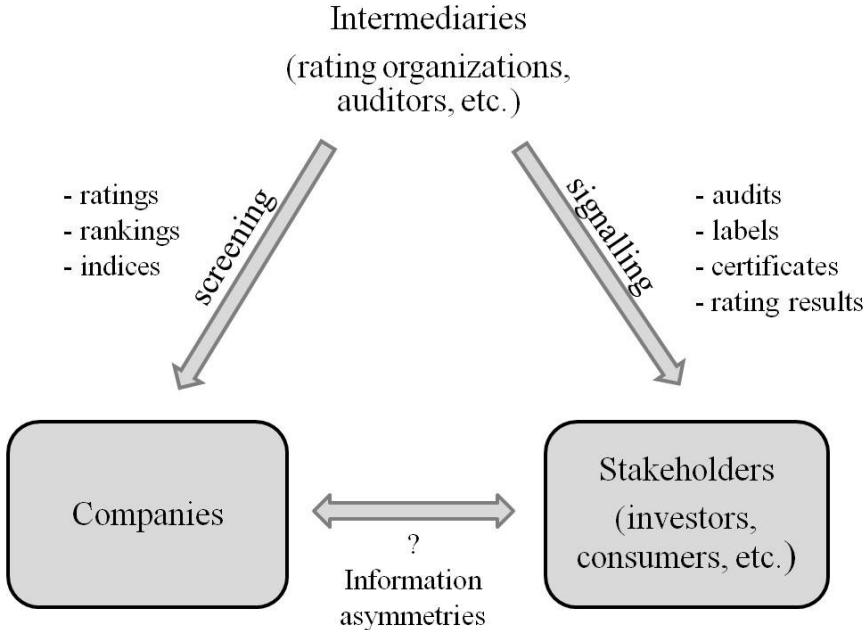


Figure 1: The role of intermediaries for signaling and screening

2.2 Development of the CS rating market

CS ratings have become increasingly practice-relevant (Chatterji & Toffel, 2010; Schäfer et al., 2006). Whereas conventional, finance-related ratings are used to estimate the credit worthiness of companies (Healy & Palepu, 2001), sustainability-oriented ratings serve to systematically and regularly analyze environmental, social, and economic issues and performance of corporate activities, systems, and processes. Furthermore, they allow the comparison of companies in terms of CS (Chatterji et al., 2009; Schäfer et al., 2006; Finch,

2004; Graafland et al., 2004). Sustainability ratings are carried out by various organizations, among them specialist rating agencies, analyst departments in banks ('inhouse research'), operators of (securities) indices, classic credit rating agencies, and few NGOs (Delmas & Blass, 2010; Schäfer et al., 2006; Finch, 2004) (see table 1, p. 3). Most CS ratings have been launched within the last ten years, mainly because institutional investors are increasingly interested in sustainability-related or socially responsible investments (SAM & PwC, 2010; Schäfer et al., 2006; Moskowitz, 1997). Today, an independent market for the services of CS intermediaries has developed, and it is expected to grow due to the rising social awareness of environmental and social issues and related market demands. For example, the number of assessed companies for *SAM's Corporate Sustainability Assessment* increased from 468 in 1999 to 1,237 in 2009 (SAM & PwC, 2010).

Among the variety of CS assessment approaches ratings play a special role, since they not only constitute an assessment approach themselves, but also form the basis for further assessment and benchmarking approaches like rankings and indices (for a detailed overview of several ratings see Schäfer et al., 2006; for an overview of the methodologies of major sustainability indices see Fowler & Hope, 2007). Therefore, the procedures that ratings apply have consequences for subsequent approaches.

Despite the visible efforts to assess CS, related approaches and particularly ratings are criticized in both research and practice (Delmas & Blass, 2010; Hansen, 2010; Chatterji et al., 2009; Fowler & Hope, 2007, Chatterji & Levine, 2006; Schäfer et al., 2006; Beloe et al., 2004; Graafland et al., 2004; Dillenburg et al., 2003; Figge & Schaltegger, 2000). Hence, Beloe et al. (2004, p. 29) conclude that many research organizations "will have to fundamentally review many aspects of their research methodology and approach". The challenges that come along with CS ratings will be discussed based on a literature review in the following. Several practice-relevant ratings are drawn upon for illustration purposes where appropriate.

3. Challenges for CS ratings

Challenges for CS ratings are dealt with in research as well as in practice literature. In this chapter, six important aspects will be identified and elaborated: standardization, transparency, bias, weighting tradeoffs, credibility of information, and independence. Table 2 offers an overview of these challenges and their meaning.

Rating challenges	Meaning
Standardization	Diversity of approaches and results, no evaluation of approaches, no comparability (Chatterji et al., 2009; Beloe et al., 2004; Graafland et al., 2004)
Transparency	Rarely full disclosure of criteria, threshold values, measures, etc. (Delmas & Blass, 2010; Chatterji et al., 2009; Fowler & Hope, 2007; Graafland et al., 2004; Dillenburg et al., 2003)
Bias	Emphasis on economic, environmental, or social dimension; focus on investors' needs; focus on larger companies (Chatterji & Toffel, 2010; Fowler & Hope, 2007; Beloe et al., 2004)
Weighting tradeoffs	Aim at single score, possibility of compensation of unsatisfactory partial results (Delmas & Blass, 2010; Graafland et al., 2004)
Credibility of information	Companies can influence rating results to a certain extent, missing verification of information (Fowler & Hope, 2007; Beloe et al., 2004; Healy & Palepu, 2001)
Independence	Relation between rating organizations and companies (AI CSRR 2008/2009; Beloe et al., 2004; Healy & Palepu, 2001)

Table 2: Challenges for ratings assessing CS

3.1 Standardization/Best-practice

Although CS ratings have spread, little standardization has been achieved yet. This is the result of the varying interests and perceptions that rating organizations and their stakeholders have in terms of CS. Beyond that, even those ratings that actually do address the same issues and interests apply varying measures. The competing approaches and their metrics have rarely been evaluated in academic research so far, although this is regarded as crucial for the construction of ratings (Chatterji et al., 2009; Sharfman, 1996) as well as sustainable indices (Fowler & Hope, 2007).

The differences among ratings are due to the relatively young, dynamic, and competitive market that has developed (econsense, 2009; Beloe et al., 2004). Furthermore, whereas the assessed companies may aim at standardization where possible (econsense, 2009), this is not desirable from stakeholders' point of view because of their different perception of and interest in CS (Beloe et al., 2004; Graafland et al., 2004; Dillenburg et al., 2003). Hence, standardization of ratings or the establishment of best practices is unlikely for the time being.

Another cause for the lack of standardization is company-internal CS accounting and reporting (Schaltegger, 1997). Ratings use publicly available information as well as data disclosed by companies. Yet, the information gathered and communicated by companies is typically generated very differently. Especially the measurement of social issues as well as the evaluation of the influence of CS on companies' success is difficult and not organized

systematically. Therefore, the data that ratings build upon is not necessarily comparable and quality might differ. This fact can distort the rating result.

3.2 Transparency

The challenge of standardization dealt with in the prior section leads over to the second challenge, lack of transparency. It has to be pointed out positively that most of the criteria accounted for in a particular rating are not determined by the organization alone but together with third parties like NGOs or academia. This serves to ensure that ratings are more balanced and accepted and also increases transparency and accountability (Fowler & Hope, 2007). Nonetheless, the particular research components leading to rating results are rarely made fully available to stakeholders, sometimes except for key clients (Beloe et al., 2004). This applies to the way information is collected, the methodology, assumptions, calculations, weightings, threshold values, or the specific criteria of the analysis (Delmas & Blass, 2010; Chatterji et al., 2009; Fowler & Hope, 2007, Chatterji & Levine, 2006; Beloe et al., 2004; Graafland et al., 2004; Dillenburg et al., 2003). Of course, this does not apply for all ratings to the same extent, but, generally, academics as well as companies criticize these ‘black box’ approaches (Delmas & Blass, 2010; AI CSRR, 2008/2009; econsense, 2009). For example, the general part of the questionnaire used for *SAM’s Corporate Sustainability Assessment* rating is open to public, while the sector-specific questions are not (SAM & PwC, 2010; Boms, 2008). Graafland et al. (2004) point to the importance of disclosing methods and assumptions of benchmarks to stakeholders. Dillenburg et al. (2003, p. 169) criticize the missing transparency of ratings as “troubling”. As long as rating processes are not transparent because components and measures are not disclosed, their reliability may be questioned just like the reliability of the companies to be examined. This is especially important for solicited ratings where ratings’ customers, for example institutional investors, may choose their own criteria and weightings (Finch, 2004).

3.3 Bias

Related to the transparency challenge is the question of bias. Schäfer et al. (2006) state that many sustainability-related ratings are biased, that means they put special emphasis either on the environmental, the social, or the economic dimension, instead of considering them likewise. The particular bias towards economic issues is, of course, especially strong in conventional ratings that use only selective CS measures as add on. However, the same bias exists in well-established assessment approaches like the *DJSI* and, thus, *SAM’s* rating

(Fowler & Hope, 2007). Fowler and Hope (2007) find that *SAM* does not consider the three dimensions of sustainability in a balanced way. *SAM*'s assessment aims at identifying industry-specific leading ('best in class') companies measured in terms of economic, environmental, and social aspects, and focuses on those that are "most likely to turn sustainability into shareholder value" (Schäfer et al. 2006, p.101). Accordingly, social and environmental criteria weigh less than economic ones (Fowler & Hope, 2007). This also applies to *KLD Research & Analytics* (2011), whose objective is to serve investors (Chatterji & Toffel, 2010). In contrast, special interest ratings may put more emphasis on ethical (or normative) and/or environmental issues while neglecting other dimensions. One example is the sustainability analysis of the *Calvert Group* and the *Calvert Social Index* respectively, in which social and ethical aspects are analyzed in more detail than environmental aspects (Calvert Group, Ltd., 2011; Schäfer et al., 2006).

Dillenburg et al. (2003, p. 169) describe the consideration of social criteria in the assessment of large investment firms as "just a collateral service". This results from the fact that most ratings are designed to primarily fulfill the needs of their main users, investors, who focus on traditional financial analysis (Delmas & Blass, 2010; Beloe et al., 2004; Dillenburg et al., 2003). This undifferentiated approach is criticized by many authors who highlight that ratings should be suitable for a variety of stakeholders with different interests (Beloe et al., 2004; Graafland et al., 2004; Dillenburg et al., 2003).

Biases are not only relevant for the content and the target group of ratings but also for the type of companies to be rated. A lot of ratings, rankings, and indices aim at identifying sustainability leaders, for instance the *DJSI*. However, most ratings focus on larger companies and include neither small and medium enterprises nor companies from emerging countries (Fowler & Hope, 2007; Schäfer et al., 2006; Beloe et al., 2004). Consequently, sustainability leaders may not be identified by this procedure, since they are possibly not even included in the sample (Fowler & Hope, 2007). The same is true if the leaders do not take part in the rating (self-selection bias) (Figge & Schaltegger, 2000). Another difference in the selection process is the usage of an existing index as 'underlying universe' versus actively screening for sustainability-oriented companies. For example, the *Dow Jones Indexes (DJI)* serve as parent indices for the *DJSI* (SAM Indexes, 2010) and several *MSCI* indices for the *MSCI ESG Indices* (MSCI Inc., 2011), whereas the *oekom* universe also contains smaller companies and "significant non-listed bond issuers" (oekom research, 2011b).

3.4 Weighting tradeoffs

Closely connected to the bias challenge are weighting tradeoffs. Most ratings ultimately aim at producing one single score, that is a number or letter as result of their rating process. For example, *oekom*'s rating uses categories between A+ and D- (*oekom research*, 2011a), and *SAM*'s rating works with percentages (*SAM & PwC*, 2010). Expressing the performance of companies in such a simple way makes it easy to understand the position of companies and to compare it to other companies or to earlier ratings of the same company (*Graafland et al.*, 2004). Nonetheless, when creating a single score of the individual measures across the triple bottom line, rating organizations assume that "values can be reduced to one dimension" (*Graafland et al.*, 2004, p. 151) although they are "pluralistic in nature" (*Graafland et al.*, 2004, p. 140). Aiming at one single score means that shortcomings in one dimension may be compensated by a better performance in another (*Delmas & Blass*, 2010). Hence, a single score probably results in a distorted picture of the actual sustainability performance of a company and is hardly considering the multitude of aspects that CS consists of. This may also affect ratings that aim at avoiding biases.

Furthermore, CS involves the demand for continuous improvement (*de Ron*, 1998). In order to capture this improvement, rating scores only make sense if they relate to other companies or earlier times. *Graafland et al.* (2004) even demand not to conduct cross-sector benchmarking but to limit comparisons to one industry. In fact, rating results often consist of an additional comparative score. For example, *SAM* translates sustainability scores into a relative measure considering the industry (*SAM & PwC*, 2010). Still, it may be argued that especially rankings oversimplify the process of CS assessment. *Vigeo* and *Forum Ethibel* (2007) state in their rulebook on the *Ethibel Sustainability Indices* that they intentionally do not calculate a global company score or compile a ranking based on the results of the individual research fields.

3.5 Credibility of information

In order to assess CS, ratings depend on suitable information. As already discussed earlier, there is a significant lack of data availability. Thus, besides publicly available data (like company or media reports), rating organizations at least partially depend on further, more detailed self-disclosure of companies on request. A lot of companies acknowledge the signaling function of ratings and take part in surveys (*Fowler & Hope*, 2007; *Schäfer et al.*, 2006; *Dillenburg et al.*, 2003), for example through investor relations departments which communicate with analysts and investors (*Healy & Palepu*, 2001). For instance, for inclusion

in the *DJSI* companies have to “fill in a detailed questionnaire covering a wide range of weighted economic, environmental, and social factors” (Fowler & Hope, 2007).

Yet, with regard to capital markets in general, the credibility of company information may be questioned, “[b]ecause managers have incentives to make self-serving voluntary disclosures” that will not affect their competitive position (Healy & Palepu, 2001, p. 425). That is one reason why many rating organizations use additional publicly available information to verify the data (Beloe et al., 2004). For example, *EIRiS* refers to the information of “government and regulatory agencies, industry organizations, trade publications, campaigning bodies, academic and specialists' reports, and the output of other research bodies” (Schäfer et al. 2006, p. 72). However, this information does not necessarily have to be credible either. Thus, the verification of information remains a “significant challenge” for research organizations (Beloe et al. 2004, p. 29).

Additionally, Beloe et al. (2004, p. 29) observe that companies are “by far the most important source of information” for research organizations. According to *SAM*, their company questionnaire is “the most important source of information for the assessment” leading to the *DJSI* (*SAM Indexes*, 2010). *EIRiS* state that their survey serves to provide “the most recent and accurate information available” (The EIRIS Foundation and Ethical Investment Research Services, 2009). During the *oekom* rating procedure “considerable importance” is attached to the cooperation with the assessed companies (*oekom research*, 2011a). Despite the inclusion of additional information and despite the fact that many rating organizations today already fill in large parts of the questionnaires based on this data themselves (Beloe et al., 2004), these examples demonstrate that companies are to some extent still able to influence the result of rating processes.

Another important argument for the increased inclusion of publicly available data is ‘questionnaire fatigue’ that results from the intensive surveying of companies (econsense, 2009; Chatterji & Levine, 2006; Beloe et al., 2004). Companies have to spend considerable resources to take part in surveys and to interact with the research organizations (Fowler & Hope, 2007, Chatterji & Levine, 2006). One possible negative side-effect of this can be that inexperienced employees like interns are asked to accomplish the survey process, which questions the credibility of information even more (Hansen, 2010).

3.6 Independence

The relationship between companies and rating organizations established in order to get the necessary information raises the question whether rating organizations are independent. Research organizations increasingly depend on the personal interaction with companies (Beloe et al., 2004). This is especially true when the rating process is carried out repeatedly over time, which is usually the case. For example, *oekom* emphasizes the importance of the cooperation with the researched companies during their rating (oekom research, 2011a) and *SAM* describes to “proactively engage with companies” (SAM & PwC, 2010, p. 21). This close contact may be perceived critically.

The close relationship to the assessed companies might call for even more criticism in cases where ratings are conducted by rating organizations (like financial service providers) which may already have or intend to establish further business relations with the companies (e. g. consultancy, financial analysis, or mandated risks assessments) (AI CSRR, 2008/2009; Beloe et al., 2004). These aspects might create conflicts of interest. They are discussed in the European *Corporate Sustainability and Responsibility Research Quality Standard (CSRR-QS)*, a quality standard for CS and SRI research launched in 2003 (see www.csrr-qs.org). Another potential conflict brought up by Healy and Palepu (2001) is the personal interest of financial analysts in certain screening outcomes: “analysts are rewarded for providing information that generates trading volume and investment banking fees for their brokerage houses” (Healy & Palepu 2001, p. 417). This may encourage upward biases of rating results.

Another relevant aspect in this context is the distinction between solicited and unsolicited ratings. Solicited ratings are carried out for a particular client and paid for (Finch, 2004). This fact also puts into question the independence of rating organizations and rating results.

So far the paper has identified six challenges that come along with CS assessment through ratings. Having a closer look at these challenges, it seems that they are not all rating-specific, but that their causes are more general aspects when assessing CS. In the following, the paper analyzes in how far CS ratings face specific difficulties by discussing whether the challenges are related to CS assessment in general and also apply to other screening approaches.

4. Discussion: Are the identified challenges rating-specific?

The six challenges that CS ratings face have been identified as standardization, transparency, bias, weighting tradeoffs, credibility of information, and independence. In the following, the paper discusses the causes of these challenges.

4.1 Rating standardization and the complexity of CS

The lack of *standardization* of ratings is not only the outcome of the competitive market for ratings but also the result of the *complexity of CS*. Even if there were a commonly accepted definition of the concept, it would still be highly complex. Research and practice have widely agreed upon the triple bottom line approach requiring the mutual consideration of environmental, social, and economic aspects (Elkington, 1997). According to this approach, CS comprises a contribution to sustainable development of companies on the one hand and to the environment, society, and economy on the other (Loew et al., 2004; Schaltegger & Burritt, 2005). CS therefore has to be assessed not only with regard to its various constituent parts, but also to long-term or rebound effects and further interdependencies (Wiedmann et al., 2009; Stahlmann & Clausen, 2000). Furthermore, the outputs or results of CS cannot be traced by “focusing on what goes on within the factory fences, farm gates, or company premises” (Wiedmann et al., 2009, p. 362). CS typically crosses companies’ boundaries, which implies that their sustainability performance is not only to be assessed in terms of internal measures but also of ‘impact’ (Epstein, 2008; Wiedmann et al., 2009). Assessment on the impact level is dealt with more closely for example in development agencies, and despite those agencies’ long experience it still remains a complex issue (Roche, 1991).

The consequence is that companies’ sustainability performance is very difficult to assess (Graafland et al., 2004). That is why a large variety of internal and external approaches that deal differently with the assessment of CS exist. Of course, this applies for ratings and their varying methodologies, too, and makes standardization efforts like that of the *Association for Independent Corporate Sustainability and Responsibility Research* (AI CSSR, 2008/2009) or *SustainAbility’s ‘Rate the Raters’* research program (Sadowski et al., 2010) necessary. Accordingly, the challenge of missing standardization is not rating-specific but results from the concept CS itself and affects other assessment approaches like labels or audits, too.

4.2 Rating bias and the integrative and evaluative character of CS

Another aspect discussed is the *bias* of many ratings towards economic factors. As already described, the emphasis on economic issues is a result of the increasing interest of the capital market and conventional analysts in sustainability. However, putting special emphasis on either one of the economic, environmental, or social dimension is inconsistent with the *integrative character* of CS. According to that, companies are required to simultaneously take account of and harmonize the environmental, social, and economic dimension (Schaltegger & Burritt, 2005).

Nevertheless, this requirement does not imply that results should not be edited according to the particular interests of stakeholders. On the contrary, it is desirable to address a large number of interest groups with CS ratings in order to enhance their acceptance and to promote sustainable development. The interpretation of a particular assessment is up to evaluation by stakeholders with differing perceptions of and interests in CS. Thus, the results of an assessment should be offered to stakeholders in a way that enables them to carry out their own evaluation. So far, most ratings are not designed to handle this *evaluative character* of CS, since they focus on conventional financial analysts.

This particular bias to economic factors is in fact to some extent a rating-specific problem resulting from the originally finance-related character of ratings and demands of the practice. Nonetheless, biases opposing the integrative character of CS are a challenge that other assessment approaches have to face alike, for example empirical studies by research institutions which include complex statistical analyses and therefore primarily address experts. The reliable assessment of CS with an integrative approach is therefore not a rating-specific but a general challenge for several approaches.

4.3 Rating weighting tradeoffs and the process character of CS

Many ratings aim at a single score and therefore allow for *weighting tradeoffs*. On the one hand, one single score is hardly taking into account all facets of CS. Companies are required to embed sustainability management in conventional management instead of dealing with it in parallel. This implies that CS has to be linked to their strategy and core business as well as to day-to-day processes in all organizational units (Schaltegger et al., 2010; Stubbs & Cocklin, 2008). This integration challenge complicates the assessment of CS, since activities, outcomes, and budgets are the more difficult to identify as sustainability-oriented the better they are integrated. One single score is hardly able to reflect these interdependencies properly.

On the other hand, CS is not a state to be reached (Epstein, 2008; Schaltegger & Burritt, 2005; de Ron, 1998). Instead, the concept occupies the demand for continuous improvement which shows its *process character*. Hence, an evaluation of CS should be carried out in relative terms and requires the comparison to a benchmark like the industry. One single score can only accomplish this through comparison to other scores.

Weighting tradeoffs are a rating-specific challenge in so far as results in the form of single scores are easy to compare and, thus, suitable for investment decisions. Additionally, many rating results also serve for use in rankings which makes it inevitable to have a single,

comparable figure. Therefore, weighting tradeoffs result from demands of the practice. Beyond that, the communication of the results of CS assessments in a comprehensive and, at the same time, complete manner is challenging for other approaches, too.

4.4 Rating credibility of information and the lack of data availability

The question of *credibility of the information* that ratings use can directly be related to the general *lack of CS data availability*. This problem affects internal as well as external measurement. Whereas internally the major problems are mostly matters of knowledge, information systems, and other management tools (Schaltegger, 1997), externally the question is rather one of limited data access. Most of the information required, if collected at all, is sensitive and rarely made publicly available (Lyon and Maxwell, 2006). Thus, not only rating organizations but all providers of CS assessments depend on further self-disclosure of companies in addition to publicly available data. Therefore, suitable internal assessment is indispensable for the accomplishment of external assessment (Chatterji & Levin, 2006). Accordingly, the problem of questionable credibility of information is not rating-specific, but results from the general lack of CS data.

4.5 Rating independence

The *independence* of ratings is another story. Contact between the rater and the companies may be unavoidable, but in order to guarantee an objective assessment the relation should not be closer than necessary. In order to reliably assess CS, rating organizations should, therefore, not have further bonds with companies and subsequent incentives to manipulate their results. Graafland et al. (2004, p. 139) argue that independent researchers should carry out the analysis in a “disinterested way”. This problem is a matter of governance. As rating organizations often do not only carry out ratings but have intermingled relations to the assessed companies, their independence and objectivity have to be questioned.

This aspect opposes the idea of a reliable assessment of CS and is reflected in a recent survey conducted among sustainability experts by *Globescan* and *SustainAbility* (Globescan, 2010). The survey shows that among different raters, NGOs are most trusted, followed by a company’s employees. Rating and ranking organizations come only in the third place, mainstream investors even later. When asked about the trust in particular ratings and rankings, the highest ranked approach, the *DJSI*, was classified as “highly trusted” by not more than 48 per cent of the respondents (Sadowski et al., 2010).

This lack of belief in the credibility of ratings and the related organizations is, on the one hand, a rating-specific problem that cannot be ascribed to general difficulties when assessing CS. On the other hand, the situation is comparable to that of certifiers and auditors (Epstein 2008; Finch, 2004). Epstein (2008, p. 246) states that “some observers have wondered whether, as with financial auditors, verifiers should act as both consultants and auditors [...]”. Finch (2004, p. 17) finds that “the provision by auditors of non-audit advisory services to companies undermines the independence of the audit”. In a similar context, Jahn et al. (2005) describe the necessity of reducing auditors’ dependency on the companies to be certified with regard to quality labels in the food market. Thus, the challenge of independence does not affect all assessment approaches, but particularly those organizations that have further relations to the assessed companies.

4.6 Lack of transparency of ratings

The aspect of independence is linked with the *lack of transparency* of ratings. When rating organizations do not disclose their weightings, threshold values, methodology, etc., stakeholders cannot tell what exactly ratings measure or assess. As long as they lack transparency, the credibility and reliability of ratings may be questioned just like the reliability of the companies to be examined. The survey by *Globescan* (2010) shows that stakeholders in fact do question the credibility of ratings.

This particular challenge results primarily from the young competitive rating market and the aim to maintain commercial advantage. Therefore, it is partly rating-specific. However, it has to be pointed out that some organizations are already more transparent than others. For example, Beloe et al. refer to *Ethibel*, *SAM Research*, and *Vigeo* as best practice organizations (Beloe et al., 2004). Transparency is also discussed with regard to other “quality assurances and the substantiation of socially relevant claims” (de Boer, 2003, p. 261), for instance certification processes for labels and audits (Müller, 2006; Jahn et al., 2005, de Boer, 2003).

4.7 Summary

In summary, and as table 3 shows, some of the challenges identified when analyzing CS ratings can be ascribed to *general challenges when measuring CS*: The *lack of standardization* and *questionable credibility of information* are results of the *complexity of CS* (including heterogeneous perceptions and expectations of various stakeholders) and the *lack of availability of CS data*.

Meeting these general challenges which hinder CS assessment requires the contribution of various disciplines and actors in research and practice. In the specific context of ratings, for example, possible solutions to overcome the ‘questionnaire fatigue’ could be the enhanced use of online tools (Beloe et al., 2004) or coordinated research of several information providers like that of the *Sustainable Investment Research International Group (SIRI)* (Chatterji & Levine, 2006; Schäfer et al., 2006).

Furthermore, some aspects that in part even oppose the idea of CS (in a narrow sense) result from the demands of investors as ratings’ main users: *bias* and *weighting tradeoffs*. These challenges are *partly rating-specific*, because the particular bias towards economic issues and the demand for simple, comparable results derive from the expectations of ratings’ main stakeholders, investors, and from bringing CS to mainstream markets.

Avoiding rating *biases* could be facilitated through the application of a more complete understanding of CS. In the context of financial market, identifying further *Business Cases for Sustainability* (Schaltegger & Wagner, 2006) might help to accomplish a shift in the perception of CS from ‘knock-out criterion’ to a more (economically) relevant aspect. However, this does not oppose tailoring rating processes to the specific need of stakeholders. In contrast, it is desirable to enable further stakeholders with differing interests to make use of ratings and their results. Another possible step to reduce biases is the extension of ratings to small and medium-sized enterprises. The same holds true for *weighting tradeoffs*: The publication of detailed information on the calculation of a final score could serve to increase the interest of further stakeholders. Related integration efforts are welcome on either side of research and practice.

Last but not least, two aspects cannot be declared consequence of general challenges and neither are they the result of investors’ demands: *questionable independence* as well as *lack of transparency*. These challenges are *partly rating-specific*, because they result from the characteristics of rating organizations and the particular market for financial services that they belong to. However, independence and transparency are also relevant for other CS assessment approaches like audits, certificates, and labels. Here it shows that screening and signaling approaches are interrelated (see figure 1, p. 6).

In order to increase their *transparency* rating organizations could disclose their methods, measures, and the content of their surveys. This holds true for other assessment approaches like audits, labels, and certificates as well. A further possibility to increase the reliability of ratings and rating organizations is to make use of independent assurance. Another aspect is

the *independence* of rating organizations. In order to provide reliable information and to enhance their credibility, rating organizations could, at least, disclose potential conflicts and how they are handled. At best, of course, those conflicts should be avoided and analysts completely independent. This applies for other intermediaries carrying out audits or assessments, too, be it on the general capital market or regarding CS in particular. Besides self-imposed principles, the establishment of standards might help to increase trust in those research organizations. Further research in this area should be a sound combination of practice demands and theoretical contributions.

Table 3 offers a summary of the aspects discussed in this chapter.

Rating challenge	Cause	Rating-specific?
Standardization	Complexity of CS	No, general challenge for CS assessment
Credibility of information	Lack of data availability	No, general challenge for CS assessment
Bias	Varying stakeholder interests	Partly, economic and other biases result from the needs of investors as ratings' main users
Weighting tradeoffs	Demand for simple and comprehensible results	Partly, investors particularly demand comparable, simple figures
Transparency	Young rating market; maintain commercial advantage	Partly, similar for audits, certificates
Independence	Intermingled business of information intermediaries	Partly, organizations with further relations to assessed companies are particularly affected (typical for financial service providers), similar for audits, certificates

Table 3: Analysis of the identified rating challenges – causes and rating-specificity

5. Conclusion: Are CS ratings suitable to assess CS?

The paper has shown that ratings, on the one hand, are a practice-relevant approach to assess CS externally. On the other hand, certain characteristics of ratings call for criticism of research and practice. Therefore, this paper served to assemble the six main rating challenges: standardization, transparency, bias, weighting tradeoffs, credibility of information, and independence.

An analysis of these rating challenges showed that interestingly none of them is really rating-specific. Instead, the various challenges can either be ascribed to general challenges when

measuring CS (lack of standardization and questionable credibility of information), result from the demand of investors as the main rating users (bias and weighting tradeoffs), or also apply for other external assessment approaches like audits, labels, or certificates (transparency and independence).

Therefore, the question raised in the beginning, whether ratings are suitable to assess CS reliably, can definitely not be answered negatively. Ratings do not involve specific weaknesses which make them unsuitable to assess CS. Instead, they fulfill an important function with regard to overcoming the information asymmetry that come along with CS. Beyond that, ratings can push companies to a more sustainable behavior, foster the institutionalization of information management, and stimulate competition between companies (Fowler & Hope 2007; Levine & Chatterji, 2006; Graafland et al., 2004; Dillenburg et al., 2003). What is needed now is a “second generation” of ratings and related research (Beloe et. al, 2004, p. 3).

The challenges identified in this paper can be used to show the way for further developments of ratings. Especially those challenges that are partly rating-specific should be tackled proactively in order to increase the suitability, acceptance, and uptake of ratings as CS assessment approach. Last but not least, the paper has shown that the concept of CS features several general characteristics which make it difficult to assess. Getting these aspects under control requires further research from various disciplines and actors in research and practice and is a process in its own right – just like CS itself.

(7,454 words)

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