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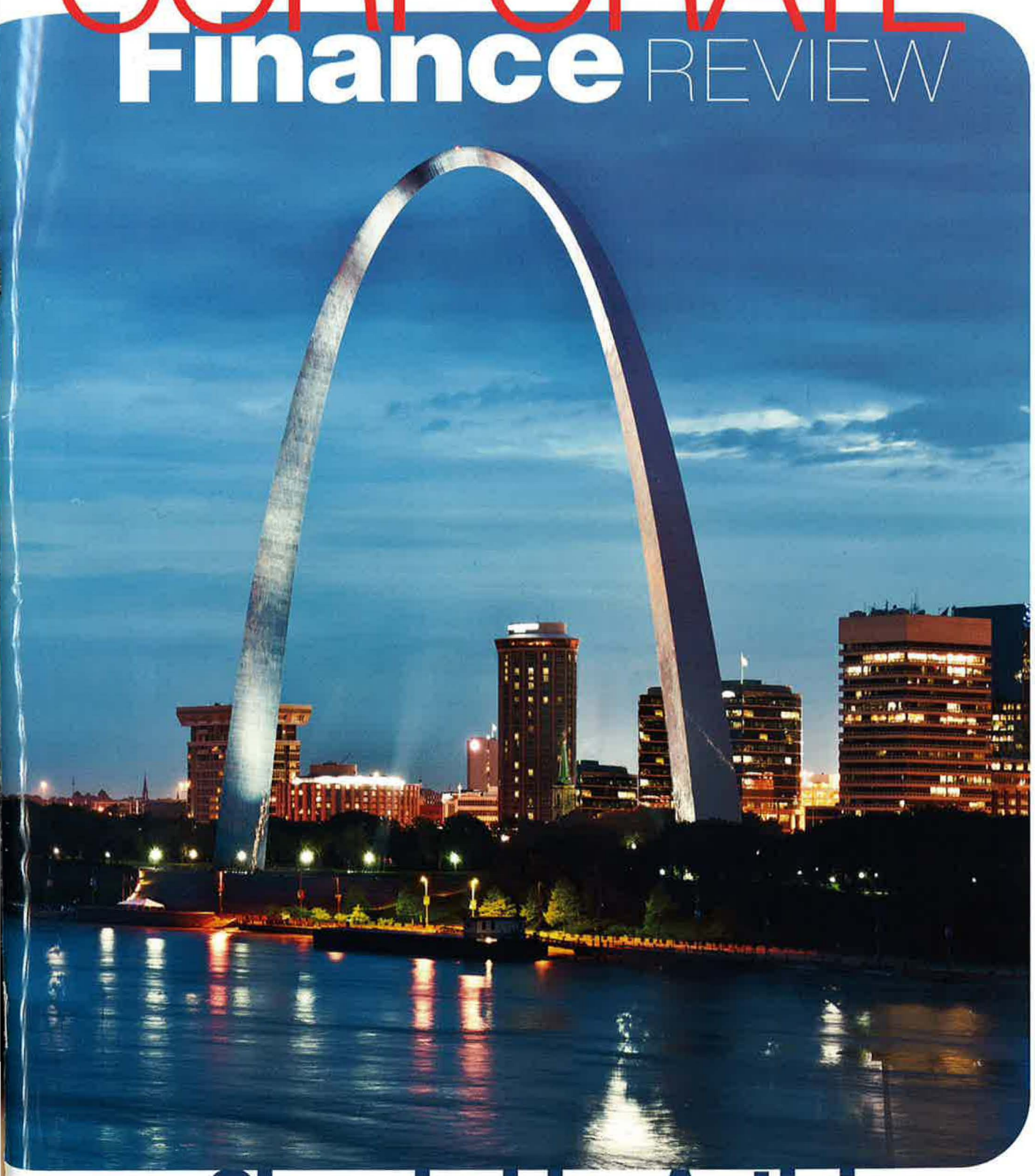
CORPORATE Finance REVIEW



Shareholder Activism

The Harvard Swap

News Announcements and Stock Prices

No Such Thing as a Rogue Trader

CORPORATE Finance REVIEW

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PAYING ATTENTION TO THE DRAGONS THAT MAY NOT BE ON THE ACCOUNTING MAP

Early seafaring explorers setting out to find fabled lands of riches far over the horizon were guided by maps drawn by cartographers with little knowledge of vast areas of the world's oceans that were then uncharted. Some c. 1500's maps bore the Latin lines "Hic Sunt Dracones"—*here be dragons*—to warn those sailors braving unknown oceans not to stray far from the familiar sea lanes charted by navigators on earlier voyages.

Today's navigators can ignore such legends with the benefit of satellite feeds (to the GPS device), and the knowledge of "gyres," which are the vast systems of slowly swirling currents in the Pacific, Indian, and Atlantic oceans (we know one familiar gyre, the Atlantic's Gulfstream current). Perhaps these currents were among the unseen dragons of yesteryear that posed dangers to early explorers whose voyages ended in mystery or tragedy.

Corporate executives may be experiencing some types of *gyres* in their transactions with analysts these days, or in the engagements with investors. A growing number of asset owners and asset managers, and a host of related service providers, could represent a type of *here be dragons* to those managers unfamiliar with sweeping changes taking place over the past six or seven years among financial institutions that they deal with.

The 1929 stock market crash, which helped to create great uncertainty about corporate accounting and reporting, led to inquiries and legislative action; the resulting 1933 and 1934 securities legislation (statutes) and the rule-making exercises that followed were intended to address some of the issues of public company accounting, disclosure, and reporting. By the end of the 1930s both formal (legislation and rules) and informal accounting and reporting standards emerged, and over the years these rules-of-the-road, navigation aids if you will, were greatly expanded. There were formal rules, and widely-accepted accounting "principles," regulatory staff bulletins, accounting industry interpretations and so on from such bodies as the Securities & Exchange Commission, the American Institute of Certified Public Accountants (AICPA), and a new organization authorized by the Congress, the Financial Accounting Standards Board (FASB, created in 1973).

What steadily emerged over the past 75 years were the Generally Accepted Accounting Principles (US GAAP) that today influence both corporate accounting and reporting and investor reaction to same. Eventually just two organizations would be authorized to set such standards under Sarbanes-Oxley legislation (2002): FASB and the SEC. We could say today that many aspects of corporate accounting and related financial matters are well-settled and a very broad common understanding is to be found in the familiar GAAP.

Look there on your desk or in the nearby bookshelf for your copy of the US GAAP rules and interpretations. The scope of GAAP has become very broad—as example, "The GAAP Practice Manual" offered by the publisher of this journal (RIA/Thomson Reuters) grows with each printing, and right now it is at 2,100 pages, covering many items related to the balance sheet, income statement, and general specialized topics with 450 computational guidelines and 200+ abstracts from annual reports. GAAP is certainly a comprehensive body of work![1]

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Beyond GAAP: *Terra incognito* for some managers

But what you won't find in GAAP are more recently-emerged reporting frameworks and guidelines that can impact on corporate accounting and reporting in subtle or not-so-subtle ways. The new guidelines and reporting frameworks are not to be found in most traditional sources of information about corporate accounting disclosure and formal (mandated) reporting. We've commented on some of these in this space over recent years; think of the recent developments as combining various aspects of the public company's governance, environmental management and societal issue management processes into financial analysis and investment decision-making frameworks or accepted approaches that are beyond the traditional financial reporting. This is the ESG framework—which combines a company's environmental performance, social issue management, and corporate governance factors into a comprehensive framework for investment managers and analysts.

ESG: Tangible and financial to investors

The ESG factors have usually been referred to as being *non-financial* or *intangible*, but for a growing number of investors (asset owners and their managers) these factors can be as important in determining their view of a current or potential investment as the traditional *financials*, the accounting and financial statements of a public company that the majority of mainstream investors rely on. The important point here is that many mainstream investors are adopting new ways of avoiding the *dragons* in their investing.

One such important emerging, informal, non-mandated or non-regulated set of guidelines for investors was created in 2005 by the United Nations organization, in collaboration with asset owners and managers and an assortment of stakeholders; and while not yet codified in law or regulation, things seems to be moving in that direction. This is the Principles for Responsible Investment [initiative] or the "PRI," organized in 2005 by investors with two UN-affiliated partners—the UN Global Compact and the UN Environmental Programme (UNEP), which helped to manage the fledgling organization.

PRI today: 915 institutions with US$30 trillion in AUM

Much progress has been made by the PRI organization and its participating financial institutions since 2005–2006.. Today, PRI has a full-time secretariat based in New York City and a rapidly growing roster of member institutions. The concept behind the initiative: to have asset owners, managers and affiliated organizations (both for profit and not-for-profit) adopt and apply ESG guidelines (considering a corporation's environmental, social issue, and governance factors) in their analytics, investment, lending, and financing activities. (The principles were designed in part to help financial institutions address their fiduciary responsibilities.)

At the start there were just 20 institutions from 12 countries signing on; as of October 2011 there were 915 institutions from 49 countries, with collective Assets Under Management (AUM) of US$30 trillion—representing about 20 percent of the global capital markets.[2] Half are investment managers; one quarter are asset owners; service providers and research firms account for 18% of membership. Corporate finance managers will find familiar names among U.S. investor participants in PRI, including major shareholders and investment companies that are probably lenders to the enterprise, and perhaps financial firms involved in other transactions.

Among prominent U.S. organizations participating in the PRI are:

- Asset Owners–CalPERS and CalSTRS, the large employee funds of California, and the state pension systems of New York, Connecticut, Illinois, Maryland (245 in total);
- Asset Managers–AXA, JPMorgan, AFL-CIO, UBS, TIAA-CREF, PIMCO (543 total);
- Private Equity firms–Black Rock, KKR, Carlyle, and other major members of the Private Equity

MANY MAINSTREAM INVESTORS ARE ADOPTING NEW WAYS OF AVOIDING THE DRAGONS IN THEIR INVESTING.

Council (which encourages participation in the PRI).

- Related Organizations—Mercer Investment Consultants, Davis Global Investors, Bloomberg, FTSE Group, IW Financial, Interfaith Center on Corporate Responsibility, Towers Watson, and Thomson Reuters.

Well-known global players include Allianz SE of Germany; Credit Agricole of France; and the Norway Government Pension Fund (second largest Sovereign Wealth Fund in the world, on track to #1 SWF with US$600 billion AUM).

NOT ALL U.S. INVESTMENT FIRMS HAVE BEEN FAST TO EMBRACE THE PRI.

Participating institutions agree to the six principles of the PRI, which include incorporating ESG factors in their analysis and decision-making; being active investors (and encouraging public companies in portfolio to account for and report on ESG performance); promoting implementation of the principles within the investment industry; engaging in cooperative initiatives within the investment industry; and institutions themselves reporting on their ESG performance on an annual basis (now required by PRI). PRI members encourage public company management in their engagements to report on sustainability and responsibility performance using the Global Reporting Initiative (the GRI framework).

U.S. asset manager response to PRI

The influence of the PRI is being felt in the United States. AllianceBernstein became a member of PRI on November 1, 2011, stating in its announcement: "We have always supported the central premise that ESG issues can have a material impact on long-term returns. It has also been our long-standing policy to include ESG issues in our fundamental research and consider these carefully when we believe they are material to our forecast and investment decisions. If we determine that these issues are material, we address [these issues] in our forecasts, research reviews, investment decisions, and engagement. In addition, we have well-developed proxy voting policies that incorporate ESG issues and engagement. In signing the PRI, AllianceBernstein as an investment manager is publicly committed to implement all six Principles where consistent with our fiduciary responsibilities, and to make progress over time on implementation of the Principles."[3]

U.S. investor participation—Or not

But not all U.S. investment firms have been fast to embrace the PRI. The financial crisis of 2008–2009 may have been a factor in the non-participation by some familiar names of Wall Street to date. In contrast, UK and EU institutions are well represented on the PRI signatory roster.

Commenting from the annual conference of the PRI in San Francisco (October 5–6, 2011), sustainable and responsible investment pioneer Peter Kinder (founder of KLD Research, now part of MSCI), said: "The PRI represents the acceptance of incorporating environmental, social and governance (ESG) criteria in investment decision-making. It has significantly advanced an effort that began in the U.S. 40 years ago with socially responsible investors (SRI) and shareholder advocates.

"Much of PRI's success has come from Europe and Australia. Canada apart, North America has proven resistant. I regret to say I don't believe the U.S. situation will change for at least two years. Beside ... the culture gap ... regulatory barriers have existed since 2008 in the U.S."[4]

The UN PRI is not just a roster of names; the organization has a number of collaborative initiatives, including the CEO Water Mandate, to which 100 large water suppliers have been invited to participate to discuss water issues affecting companies and investors (21 companies have accepted at the CEO level). The PRI also has organized a Carbon Disclosure Project for measurement and management of emissions; and Sustainable Exchanges, an effort in which invitations are extended to stock exchanges to encourage them to institute new rules for listed companies to disclose more about corporate ESG performance.

James Gifford is executive director of UN PRI; he's been leading the organization since inception. Rob Lake, who joined PRI

from the large asset manager APG (The Netherlands) is director of strategic development, and is responsible for liaison with participating and prospective organizations.

Mr. Gifford explains that the PRI framework is designed to be a reliable resource for encouraging integrated reports on financial institution activities related to the principles.[5] (Participating investment companies are mandated to report annually or be dropped from the roster.) The PRI acts as a catalyst for action and a global hub for coordinating information about the finance sector and its lending and asset management activities, especially in emerging economies. Investors frequently use the PRI-generated information in their dialogues with public companies in portfolio.

Corporate pension funds, Mr. Gifford notes, have clear fiduciary duties, which PRI involvement can help them address; one of the largest employee benefit funds is that of Royal Dutch Shell. PRI provides webinars (some four dozen last year), an annual conference, and access to special sections of the web site for participating managements.

Partnering organizations

The UN PRI has two partnering organizations that corporate financial executives may be familiar with: The UN Environmental Programme Financial Initiative, or UNEP, has 170 public and private institutions—banks, insurers, investment companies—participating in its activities.[6] The UN Global Compact has 10 universal principles that signatories agree to uphold, addressing issues concerning human rights, labor, environment, anti-corruption measures. To date, 5,300 business in 135 countries have signed on—making this the world's largest voluntary corporate initiative focused on sustainability and ESG factors.[7]

Conclusion

While U.S. GAAP is a well-settled package of guidelines, rules, interpretations and the like, in recent years a number of informal methods of analyzing and evaluating a public company for investment management decision-making have emerged. These are becoming important factors for investors in their engagements with public company management.

Global initiatives have been organized to encourage use of the non-GAAP frameworks for corporate accounting, disclosure, and reporting. One of these frameworks is the Principles for Responsible Investment (PRI) for investors, which is widely accepted in the European Union by investment owners and managers and over recent years has been accepted by a growing number of "name" investment managers in the United States. Corporate finance managers should be more aware of the impact on their companies of informal, voluntary adoption of the Principles for Responsible Investment within the U.S. investment community, especially as these investors in their engagements with corporate management discuss ESG factors, and encourage companies in portfolio to measure, manage, and disclose more about their respective ESG performance factors. ■

NOTES

[1] "The GAAP Practice Journal," information available at http//www.RIA.thomsonreuters/estore.com. Published by RIA/Thomson Reuters, New York, NY.

[2] The full list of PRI signatories can be found at the UN PRI web site: http://www.unpri.org/.

[3] AllianceBernstein, October 21, 2011 announcement of becoming PRI participant.

[4] Peter Kinder, published comments on CSR Wire, October 19, 2011. Mr. Kinder is the co-author of *Ethical Investing* (1984); the *Social Investment Almanac* (1992); and *Investing for Good* (1993). He founded KLD Research and Analytics in 1983. Information at: http://www.csrwire.com/blog/posts.

[5] Author's conversation with James Gifford, Executive Director, PRI, and Rob Lake, Director Strategic Development, New York, New York; May 18, 2011.

[6] UN Environmental Programme; information available at: *http://www.unep.org/.*

[7] UN Global Compact information is available at: http://www.unglobalcompact.org/.