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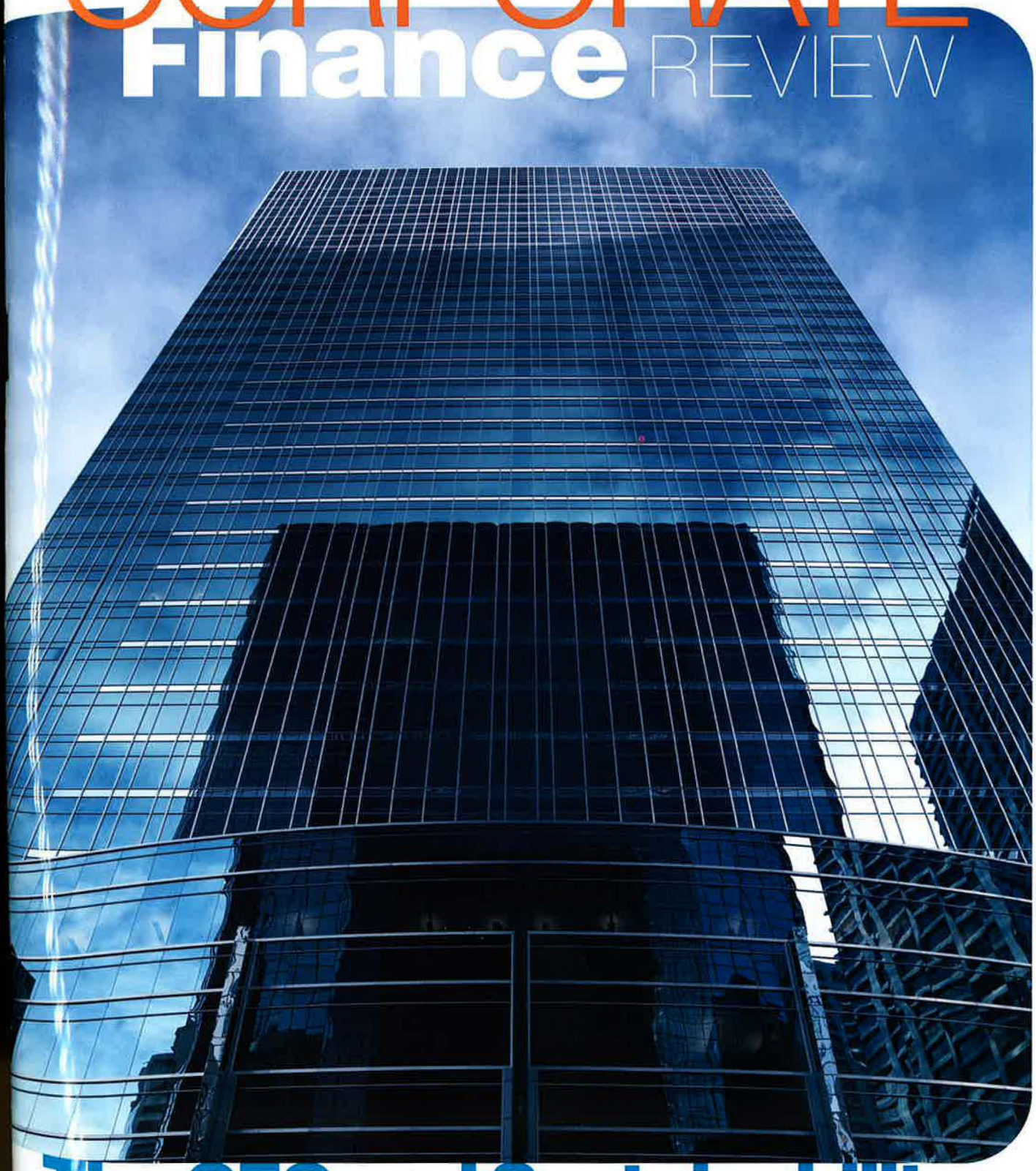
CORPORATE Finance REVIEW



The CFO and Sustainability

Negotiating Severance Packages

Direct Bank Loans to Municipalities

Psychological Bias in M&A Pricing

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TRENDWATCHING: THE COMING OF INTEGRATED CORPORATE REPORTING

We'll be a little bold here in predicting a dramatic change in corporate disclosure and reporting.

The timing is uncertain; the mood of the investors and the forward direction of the movement is much more certain. We're talking about the rising demand for "integrated reporting" — a trend that the financial executive should keep a close eye on. The perception that such reporting is necessary and would be a good thing for both issuer and investors could hasten the reality: the arrival of a combined reporting system for publicly traded companies — that is, combining the firm's traditional financial with expanded sustainability performance reporting.

We recognize, of course, that it is difficult to accurately predict the future. The literary roadsides are littered with failed predictions by experts and "those who should know." We recall that the chairman of International Business Machines (today's IBM) felt he was on safe ground in 1944 when he predicted that there was a world market for *maybe five computers* (Thomas Watson commenting on the future of his company's product).

Or the CEO of Microsoft's views several decades later, when the company launched its first PC products: *640k ought to be enough for anybody* (Bill Gates, 1981).

Perhaps this is the worst prediction that we can recall: *Everything that can be invented has been invented* (quoting Charles Duell, Commissioner of the U.S. Office of Patents, 1899, just as technological and scientific advances would explode in volume, leading to fantastic growth in patent filing).

So the danger one sees here in being too precise or too prescient for a commentator in making such predictions...you may be quoted endlessly.

At the risk of being roadside prediction litter, we venture boldly forth with these suggestions.

Watch the effort made by global collaborators, who are intensely focused on developing "integrated reporting" by publicly traded corporations and fashioning the standards for doing so. The concept here is that expanded corporate reporting should include both the traditional financial results plus expanded disclosure and communication on *intangible or non-financial information* related to the enterprise's environmental issues, social or societal issues, and corporate governance performance (ESG). (ESG is also commonly referred to as "sustainability" factors for investors. Analysts and asset managers refer to the concept in both ways.)

The International Integrated Reporting Council (IRRC) was formed two years ago to advance new approaches for global corporate reporting that would "demonstrate the linkage" between a company's strategy and governance and its financial performance.[1] This is already being done by a handful of U.S. and non-U.S. companies on a voluntary basis (U.S. companies publishing integrated reports have included PepsiCo, Clorox Company, and United Technologies).

The IIRC published a paper in September 2011 that set out the rationale for an integrated reporting framework.[2] This document is a primer for the corporate executive on the subject.

Investor demand rising

A coalition of investors representing $1.6 trillion assets under management (in concert with financial institutions, pro-

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fessional organizations, and NGOs) called on United Nations member states to adopt a global policy framework for integrated reporting when they convened at the Rio "Earth Summit" in 2012. The Corporate Sustainability Reporting Coalition was led by Aviva Investors, the Association of Chartered Financial Accountants, Generation Investment Management, the Global Reporting Initiative, and Hermes pension fund management. This was one of several such proposals floated as the Rio conference neared.

Paul Abberly, CEO of Aviva (London), said, "As long-term investors we recognize the positive impact that embedding long-term sustainability into a business strategy can have on shareholder value."[3]

THE PILOT PROGRAM OF IIRC HAS MORE THAN 75 BUSINESSES PARTICIPATING IN HELPING TO DEVELOP STANDARDS BY PROVIDING FEEDBACK ON "KEY BUILDING BLOCKS."

Investors participating in the IIRC include:

- Hermes EOS (which manages the BP pension scheme);
- InterAmerican Development Bank;
- Rockefeller Financial;
- PGGM (The Netherlands);
- Norges Bank Investment Management (which manages the $600 billion Norway Government Pension Fund, which invests in several thousand companies);
- Pax World (USA); and
- Calvert (USA) (the latter two are prominent SR investors).

The pilot program of IIRC has more than 75 businesses participating (it was launched in October 2011) in helping to develop standards by providing feedback on "key building blocks." By October 2013, the organization plans to have a framework ready for public examination.

The chairman of the IIR is Mervyn King, a prominent South African jurist and bank executive. You may recall that he was chair of the Global Reporting Initiative (GRI). GRI framework has become the de facto global standard for corporate and institutional sustainability (ESG) reporting. His successor, Herman Mulder, is a member of the IIRC Council.

Other members include:

- Peter Bakker, president of the World Business Council for Sustainable Development (WBCSD);
- Paul Dickinson, executive chairman of the Carbon Disclosure Project (CDP);
- Robert Greenhill, managing director of the World Economic Forum;
- Hans Hoogervorst, chairman of the International Accounting Standards Board (IASB);
- Wolfgang Engshuber, president of corporate centers, Munich Re America, and director of Munich Re Capital Markets; and
- Richard Saman, chair of the Climate Disclosure Standards Board.

The organization has established regional roundtables to collect input from stakeholders in London, Mumbai, Davos, Sydney, São Paula, Brussels, New York City, Amsterdam, Rome, Moscow, Berlin, San Francisco, Tokyo, and other locations. Participating organizations have included the (U.S.) National Investor Relations Institute (NIRI); chartered accountant organizations in Australia; Bangladesh; Dubai; United Kingdom's Prince's Accounting for Sustainability Project; World Economic Forum (Davos); BOVESPA (the Brazil stock exchange); and the Global Reporting Initiative.

Some countries and stock exchanges are not waiting; in 2009, the Johannesburg Stock Exchange (JSE) adopted the "King Code of Governance for South Africa," which requires all JSE-listed companies to create an integrated report for fiscal years beginning (after) March 2010. If they do not, companies are required to state why they do not report.

In the United States of America

Watch: In the United States, the new Sustainability Accounting Standards Board (SASB) was recently organized as a not-for-profit organization for the "purpose of establishing industry-based sustainability standards for the recognition and disclosure of material environmental, social, and governance (ESG) impacts by companies traded on U.S. exchanges."[4]

The founders' "vision" is that all forms of capital — financial, human, and natural resources — will be accounted for and managed for both current and future generations. "Integrated" reporting of sus-

tainability fundamentals with financial fundamentals will better enable investors (and stakeholders) to compare a firm's performance with other companies and help management and board better understand risks and opportunities — and, of course, in the process, "adjust" behaviors as appropriate.

SASB will use a multistakeholder approach to help define the critical ESG materiality issues within each industry and will work to produce a set of concise, industry-based sustainability accounting standards. The work will be designed to complement the work of the Financial Accounting Standards Board (FASB) and to support the U.S. Securities & Exchange Commission work related to defining materiality of sustainability issues. Standard disclosure Forms 10-K and 20-F are in focus for the new SASB.

SASB HAS A "HEAVYWEIGHT" BOARD OF DIRECTORS WITH DEEP EXPERIENCE IN CORPORATE DISCLOSURE, STRUCTURED FINANCIAL REPORTING, AND CORPORATE DISCLOSURE PRACTICES.

The idea seems to have come from the research at the Initiative for Responsible Investment at Harvard University, with a focus on "how" to determine that nonfinancial/intangible materiality[5] could be applied at the industry level. Six industries were test cases for developing the methodology: airlines, autos, banking, pulp & paper, REITS, and electric utilities.

At the same time, Harvard professor Robert Eccles and colleague Mike Kruz were finishing their book *One Report*, which served as a call to action for forward movement on adoption of integrated reporting (financial and sustainability performance). The authors saw Form 10-L as the "ultimate" single (or "One") report (Michael Kruz is an expert on integrated reporting, and Bob Eccles is Harvard University professor of management practice).[6]

Powerful minds at the center of SASB

SASB has a "heavyweight" board of directors with deep experience in corporate disclosure, structured financial reporting, and corporate disclosure practices. They are moving the concept forward. The board of directors includes:

- *Robert Eccles* (Chairman of the Board), corporate governance expert, professor of management practice at Harvard Business School; also a member of the steering committee of the IIRC;
- *Dan Hanson*, managing director and portfolio manager of BlackRock; also a member of the U.S. Large Cap Series equity team;
- *Erika Karp*, the influential managing director and head of global research of UBS Investment Bank, managing sector analysts and strategists around the world;
- *John Katovich*, founder and partner of K2 Katovich and Kassan Law Group; former officer of the Pacific Stock Exchange (general counsel) and of the Boston Stock Exchange (EVP and general counsel);
- *Steve Lydenburgh*, partner for "strategic vision" of Domini Social Investments and Standards Council Chairman of the SASB;
- *Susan Mac Cormack*, partner in the corporate group of the Morrison & Foerster law firm; also co-chair of the Cleantech Group;
- *Aulana Peters*, retired partner, Gibson, Dunn & Crutcher law firm; former member of the AICPA Public Oversight Panel, member of steering committee of the FASB Financial Reporting Project, and member of the board's Blue Ribbon Panel on Audit Effectiveness; also a director at Deere & Company, Northrup Grumman, 3M, and the Mayo Clinic;
- *Anne Sheehan*, head of corporate governance at the California State Teachers Retirement System (CalSTRS), one of the nation's large public employee pension systems and a leader in corporate governance reforms;
- *Edward Waltzer*, partner in Stikeman Elliott law firm and former professor of law at Osgood Hall Law School; was chair of the Ontario Securities Commission and vice

president of the Toronto Stock Exchange; and

- *Dr. Jean Rogers,* the founder and executive director of SASB and not a voting board member; was a management consultant at Deloitte (working in the environmental and management practices) and was a principal at Arup (a global consultancy focused on sustainable development).

An idea whose time has arrived?

Is "integrated reporting" an idea, a concept whose time has arrived (for action)? For a growing number of investors, the emphatic answer is "yes." A growing number of corporate managers agree and have embraced at least the first half — voluntary sustainability, ESG, corporate responsibility, and "citizenship" reporting (General Electric and a few other firms use that designation). The preferred framework for such reporting is the Global Reporting Network and its G3 (or 3.1) standards. The GRI is in the process of expanding the framework (the G4 is in development), which could include much more emphasis on the relation and aspects of corporate finance to the ESG performance indicators and on disclosures inherent in the present standards.

It would be prudent for corporate financial professionals to tune in to the evolving issue of integrated reporting, especially as the subject is raised by asset owners, their managers, members of investor coalitions, multiparty initiatives (such as described here), and other stakeholders. We will venture out on that limb and predict here that, in both good and bad market times, this idea is not going away any time soon. ■

NOTES

[1] See the website www.theiirc.org for details of the International Integrated Reporting Council.

[2] "Towards Integrated Reporting — Communicating Value in the 21st Century" is available at http://www.theiirc.org. See Resources.

[3] Sullivan, R., Connecting the dots — Integrated reporting, *CFO World.* This article is an excellent summary of the work of the Corporate Sustainability Reporting Coalition. Available at: http://www.cfoworld.com.au/management/535545/connecting-the-dots-integrated-reporting/

[4] SASB sees the definition of materiality as "defined as information which represents a substantial likelihood that its disclosure will be viewed by the reasonable investor as significantly altering the total mix of information made available." See details at www.sasb.org.

[5] Study results of the Initiative for Responsible Investment are available at http://www.sasb.org/wp-content/uploads/2012/03/IRI_Transparency-to-Performance.pdf

[6] Eccles, R.G. and Kruz, M.P., *One Report, Integrated Reporting for a Sustainable Strategy* (John Wiley & Sons, Inc., 2010). The authors cite companies practicing the "one report" concept: Novo Nordisk, Philips; United Technologies. Available by Kindle at Amazon.com.