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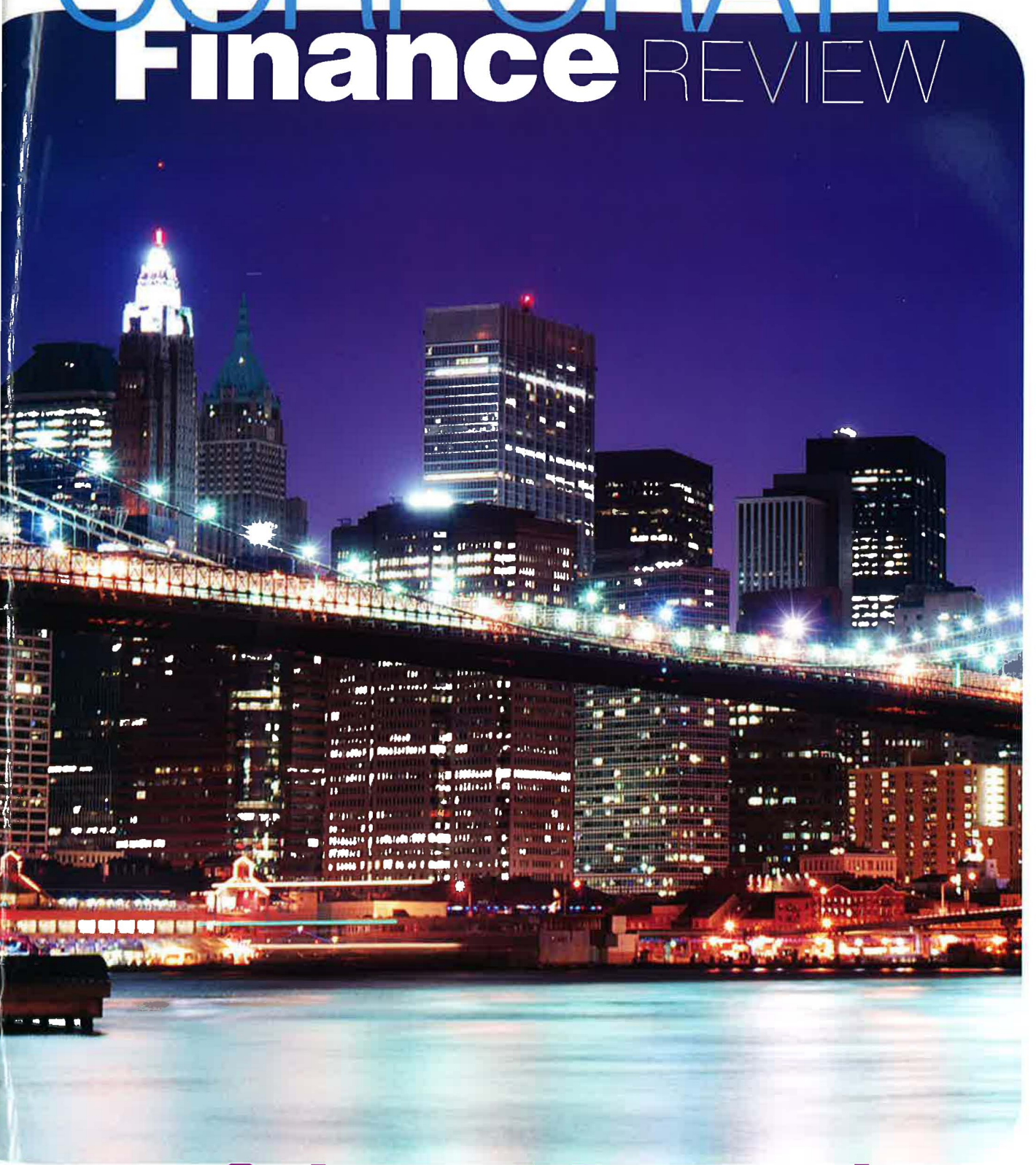

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Performance-Based Incentives

Mergers and Acquisitions in China

Protecting Against Fraudsters

CORPORATE Finance REVIEW

Contributing Editors

Marianne M. Jennings
Professor of Legal and Ethical Studies
Arizona State University

Hank Boerner
Chairman
Governance & Accountability Institute

Pablo Triana
Executive
Boisas y Mercados Espanoles

Editorial Staff

Editor-in-Chief
Morgen Witzel
mail@morgenwitzel.com

Senior Director, Financial Reporting and Management Publications
Bruce Safford

Editor
Jack Nestor
jack_nestor@technicaeditorial.com

Desktop Artist
Anthony Kibort

Advertising Sales Director
Terry Storholm
WG&L Journals Advertising
610 Opperman Drive
Eagan, MN 55123
phone: (800) 322-3192
fax: (651) 687-7374
e-mail: terry.storholm@thomsonreuters.com

Reprints
Lont & Overkamp
(973) 942-5716

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HANK BOERNER

GLOBAL CORPORATE ACCOUNTING LANGUAGE IS EXPANDING— THROUGH REGULATIONS, MANDATES, AND VOLUNTARY ADOPTIONS

It is said that beyond the spoken word, for many humans music is a language unto itself, as are the languages of mathematics, computer software, and science. Experts in those fields are as comfortable with the frameworks, nuances, idioms, and jargon of their specialties, and are as facile with their specialized language, as are financial managers with the cadence and rhythms of U.S. GAAP and the global IFRS. Financial "language" is familiar to all finance professionals, no matter what spoken language is used.

After many decades, the familiar and comfortable technical language of finance that has been learned and mastered by corporate finance executives is now changing, becoming more nuanced, and expanding beyond the comfort zone of the familiar with focus on *the numbers.* Financial analysts, asset owners, and managers are embracing new concepts—let's call it the "numbers and beyond the numbers." This is frequently referred to as the investor focus on *intangibles,* or the *non-financial* dimensions of corporate reporting.

For most of the decades of the twentieth century, legislators and national regulators focused on development of comprehensive rules and standards to provide uniform reporting of financial results, *the numbers,* especially for publicly traded companies. Securities-focused legislation in the 1930s brought order to corporate (and public sector) financial reporting that investors could rely on. The 1933 Securities Act and 1934 Securities Exchange Act were significantly expanded in 2002 with passage of the Sarbanes-Oxley package of legislation, adding a good amount of corporate governance language to existing securities law. Now more changes are in store.

Even the most ardent advocates for such laws and regulations admit that it is difficult to legislate and control human behavior. With the rise in power and influence of the institutional investor since the early 1970s, a counterbalance has emerged to "corporate power." Asset owners (such as public employee pension funds) and their hired managers are looking beyond the corporate numbers to gauge the quality of boards and management, and increasingly adopt the language of "share-owners,"— not "shareholders" or "stock-traders." The impact on corporate finance is now measurable and quantifiable.

The new language of investing: Corporate sustainability

The Big Four accounting firm Ernst & Young recently published a report on "climate change and sustainability," exploring "How Sustainability Has Expanded the CFOs' Role."[1] The paper explored the new terminology of the "triple bottom line,"—how today's shareholders expect corporations they invest in to meet standards of social, environmental, and economic performance" (each having a bottom line to be quantified and measured).

The report acknowledges that "sustainability" issues have, of course, been outside the jurisdiction of CFOs, who "ran the numbers" and let others in the enter-

HANK BOERNER is chairman of Governance & Accountability Institute, a New York-based research, monitoring, and advisory firm. G&A is the Data Partner for the United States for the Global Reporting Initiative; U.S. company and foreign subsidiary reports are compiled, analyzed, and become part of the global GRI database of reports. For further information go to: www.ga-institute.com. Hank can be reached at hboerner@ga-institute.com.

prise handle "soft" (or squishy) issues, such as social responsibility and corporate citizenship. But now those separate corporate silos are crumbling as investors, business partners, and stakeholders connect financial performance with social and environmental performance—factors which now make up the triple bottom line.

And so, says the Ernst & Young firm, chief financial officers, and other corporate finance executives are becoming more involved in measuring, managing, and reporting on corporate sustainability efforts and achievements. This is a far cry from what might have been predicted at the beginning of the last decade when CFOs were becoming familiar with the mostly financial reporting and governance-focused complexities of Sarbanes-Oxley regulations.

The accounting firm asserts that as "ESG" factors (environmental, social, and governance key performance indicators) are increasingly incorporated into investment analysis, corporate boards and senior executives are realizing that the company's social (or societal, or "citizenship") and environmental performance are contributing directly and indirectly to economic performance.

ESG information/data/language is "out there"

Consider that today more than 300,000 Bloomberg LP desktop terminals worldwide carry volumes of information about public companies' ESG performance—including corporate sustainability policies, codes of conduct, emissions data, energy consumption, board composition, and other information of interest to investors.

Rival Thomson Reuters, which purchased the respected analytics firm ASSET4 a year ago, is actively pushing out ESG data to more than 45,000 buy-side and sell-side client terminals via its Datastream® service. Financial analysts can take copious amounts of quantitative ESG data and correlate this with existing financial information for their clients.

Ernst & Young in its report notes that investor relations is the art of storytelling, and sustainability can be viewed as a "new character" in the familiar plotline. "The story is still about financial promise," the authors state, "but with a new twist: increasingly, a company's sustainability story is being heard and read by the same people who read its annual financial reports."

For the CFO: Two sides of the financial performance coin

As sustainability issues intertwine with business strategy—think of the impacts of climate change, or energy cost spikes, or availability of water for processing and products—E&Y advises readers that institutional investors are viewing financial and non-financial performance as two sides of a coin. "For that reason," the report authors say, "CFOs must stay up to date on their companies' sustainability policies and initiatives and on ESG issues more broadly."

Since its publication in the *Harvard Business Review* in the January/February 2011 issue, an article by Michael E. Porter and Mark R. Kramer ("Creating Shared Value") has created a robust dialogue among U.S. corporate executives.[2] In the article, the authors argue that the next evolution in capitalism will be the concept of "shared value," which will connect (or reconnect) company success and community success, looking beyond short-term thinking and the "age of narrow management approaches." This is an important concept for the financial executive to consider, especially coming from the pen of the very influential Michael Porter.

"We need a more sophisticated form of capitalism," state professors Porter and Kramer in their essay, "one imbued with social purposes. The next evolution in the capitalist model recognizes new and better ways to develop products, serve markets, and build productive enterprises." (The article is subtitled, "How to reinvent capitalism—and unleash a wave of innovation and growth.")

So what is "shared value"? Authors Porter and Kramer explain the concept:

> "Shared value can be defined as policies and operating practices that enhance the competitiveness of a company while simultaneously

INVESTOR RELATIONS IS THE ART OF STORYTELLING, AND SUSTAINABILITY CAN BE VIEWED AS A "NEW CHARACTER" IN THE FAMILIAR PLOTLINE.

advancing the economic and social conditions in the communities in which it operates. Shared value creation focuses on identifying and expanding the connections between societal and economic progress."

New language, indeed, for many corporate financial officers. And there's more. Beyond the familiar accounting languages of GAAP and IFRS, there are many more nuances, idioms, dialects, accents, and the like.

Voluntary and mandated standards for corporate ESG reporting

Consider these relatively recent developments: The United Nations Environmental Programme and the Global Reporting Initiative (GRI) just issued their updated report, "Carrots and Sticks, Current Trends and Approaches in Voluntary and Mandatory Standards for Sustainability Reporting."[3] (The first report was issued in 2006.) The 2011 report has comprehensive information on corporate reporting in OECD countries, and emerging markets (such as Brazil, India, and South Africa).

Highlights of the 2011 update are:

- A total of 142 countries now have standards and/or laws with some form of sustainability-related report requirement or guidance.
- About two-thirds of these are mandatory reporting requirements, and one-third are voluntary.
- At the global and regional level, there are 16 standards for reporting on ESG and sustainability (which of course includes corporate governance).
- There are 14 assurance standards being used today, many on a global basis.

On a voluntary basis, there is a steep increase in reporting based on the Global Reporting Initiative's G-3 framework standards.[4] In 2008, KPMG reported that 79 percent of the global 250 companies are disclosing ESG data, and 77 percent of those companies use GRI to do so.

Commenting on the updated UNEP and GRI report, Aron Cramer, President & CEO of Business for Social Responsibility, states:

"This new report provides a thorough and much-needed look at a fast-changing and important element of [corporate] reporting: the link to public policy on reporting. With new steps toward reporting requirements from the U.S. Securities & Exchange Commission, in addition to steps taken in China, Sweden, South Africa, and elsewhere, this publication will be valuable for both new and experienced reporters."

From GRI: The view of interdependence of financials and other assets

The Hon. Mervyn King, Chairman of the Board, GRI, and a board member of several large publicly traded enterprises, asserts that the five capital assets of *Financial, Human, Natural, Social, and Technological* are all critically independent now. "No entity can plan for the long-term in the economy in which we find ourselves without taking account of these critical, interdependent capital assets," he writes in the report foreword. "There is no time for a business-as-usual approach. The time is ripe to follow the governments who have introduced legislation on a report-or-explain basis regarding the impact which the operations of any company may have economically, societally, and environmentally."

ON A VOLUNTARY BASIS, THERE IS A STEEP INCREASE IN REPORTING BASED ON THE GLOBAL REPORTING INITIATIVE'S G-3 FRAMEWORK STANDARDS.

The global head of sustainability assurance at accounting firm KPMG, Wim Bartels, adds:

"The need for regulatory frameworks for reporting has long been debated. In this era of low trust in the corporate world, it would seem to be the duty of all parties to ensure that transparency is elevated to the level where an organization's stakeholders can understand its comprehensive performance in such a way that trust is rebuilt and decisions can be taken in an environment where dialogue is an integral part of business.

"In this context, frameworks for sustainability reporting—voluntary or mandatory—can assist those who want to be part of this world, as well as stimulating or forcing those who

prefer the old situation to report on the wider impact they have on society—negatively and positively."

For the CFO: Trends to monitor

For corporate finance executives, the emerging trends to watch are:

- Governments and stock exchanges mandating regulations with the obligation for the corporation to report on corporate ESG performance and factors. (Example: Denmark's Financial Statements Act requires CSR disclosure for large enterprises.) These mandates can include certain size companies (asset base), employee count, or state-owned companies; large emissions emitters; and energy-intensive companies.
- Various incentives for companies to report. (The carrot vs. stick.)
- Government endorsement of the GRI G-3 Guidelines for reporting and encouragement of the industry to use the framework for corporate sustainability reporting; this includes industry trade associations encouraging member reporting (the Spanish banking trade association reports to the GRI and encourages all member banks to do so).
- Voluntary rules of guidelines (including industry standards), with or without referencing international standards. We see these emerging in the jewelry business (focused on mining of "blood diamonds" and other issues); in the coffee business (fair trade protocols); and in mining and extractive industries in developing nations, especially in Africa and Asia.
- Transference of regulatory power to self-regulating organizations (such as stock exchanges) for either mandatory or voluntary reporting. (The King III Code of Governance for South Africa requires listed companies on the Johannesburg Exchange to report on sustainability.)
- Increasing pressure on boards and managements from shareholders and shareholder coalitions and networks to be more transparent regarding corporate ESG performance. (We are seeing evidence of this in the many shareholder proxy resolutions brought in the U.S. by activists focused on climate change.)

Government and exchanges advise—and mandate reporting

In the U.S., the SEC in 2010 released interpretive guidance on climate change risk (and opportunity) disclosure by public companies. That followed an earlier interpretation that boards had responsibility for overseeing risk management in their companies. Governments around the world are now mandating sustainability reporting. Sweden, for example, has *Guidelines for External Reporting by State-Owned Companies* that complement accounting legislation. India has published *Voluntary CSR Guidelines 2009* (issued by the Ministry of Corporate Affairs). Japan has issued *Environmental Reporting Guidelines 2007* (issued by Ministry of the Environment).

The World Federation of Stock Exchanges (WFE) has been active in generating sustainability reporting standards for their listed companies, especially in the emerging markets. The WFE issued a report in 2009 that demonstrated that 51 member exchanges are initiating standards for reporting by listed companies to enhance transparency and ESG-related performance and risk reporting. These include the Shenzhen Stock Exchange and Shanghai Stock Exchange in China. The Corporate Governance Council of the Australian Securities Exchange (ASX) amended its *Corporate Governance Principles and Recommendations* to include sustainability issues. The OECD Guidelines for Multinational Enterprises encourage disclosure on financial and non-financial corporate performance, including ESG issues.

And an important trend that is now emerging—the gradual integration of ESG reporting into one framework, the "integrated" report, combining the traditional annual report with the company's sustainability report. The dialogue is around the value of stand-alone reports (annual and sustainability), or the value

GOVERNMENTS AROUND THE WORLD ARE NOW MANDATING SUSTAINABILITY REPORTING.

of integrated reports, and what should be mandated, as well as the extent of non-financial information disclosed in both reports or the combined report.

Of course, state and national laws prevail in considering non-financial disclosure; company by-laws; accounting law; securities law; employment law; health and safety laws; and climate change disclosure laws and regulations.

Reporting "assurance": Similar to the financial audit process

Another important factor for corporate finance executives to consider is the growing use of third parties for (independent) "assurance" of ESG reporting. KPMG, Ernst & Young, and other accounting practices as well as specialized service providers are building practices around the "Assurance Provider" concept, which is similar to auditing of the traditional financials.

Increasing numbers of sustainability or ESG reports following the GRI framework are "assured" by third parties who provide an assurance similar in some ways to the auditing assurance. There is a wide range of methods used (no standards have yet evolved) and varying levels of inspection to assure that the data and narrative of the reports are accurate and complete.

There are several international standards for assurance that are generally accepted, including the ISAE 3000 and AccountAbility's AA1000AS standards. Country-specific standards include Australia, China, France, Germany, Japan, The Netherlands, Spain, and Sweden, according to the GRI / UNEP report.

A complete inventory of international, country, exchange, and other mandatory and voluntary standards and frameworks is available at: http://www.globalreporting.org/NR/rdonlyres/6BD446D1-C7CD-44F2-AC64-B96221D790E4/0/Carrrots2010final.pdf

The *Oxford Dictionary* defines "language" as "the method of human communication, either spoken or written, consisting of the use of words in an agreed way." Another use of the word is for "professional or specialized vocabulary."[5] The new language of "non-financials" and "intangibles" is still being formulated, with terms like ESG, sustainability, corporate responsibility, citizenship, Triple Bottom Line, and other concepts being advanced by shareholders and stakeholders.

The language of the corporate financial officer is changing rapidly, indeed! ■

NOTES

[1] Ernst & Young report, "How Sustainability Has Expanded the CFOs Role," 2011, Ernst & Young; information at E&Y Climate Change and Sustainability Services; email: *Stephen.starbuck02@ey.com*.

[2] "Creating Shared Value," *Harvard Business Review*, January/February 2011, by Michael E. Porter, Bishop William Lawrence University Professor at Harvard University, and Mark R. Kramer, Senior Fellow of the CSR Initiative at Harvard's Kennedy School of Government.

[3] "Carrots and Sticks: Promoting Transparency and Sustainability," an update on trends in voluntary and mandatory approaches to sustainability reporting; 2011, Global Reporting Initiative (GRI), Amsterdam, The Netherlands, and the United Nations Environment Programme (NewYork, New York); information at: *www.globalreporting.org*.

[4] *Corporate Finance Review*, March/April 2011, Sustainability and ESG Reporting Frameworks: Issuers Have GAAP and IFRS for Reporting Financials; What About Reporting for Intangibles and Non-Financials? By the author.

[5] Concise Oxford Dictionary, Ninth Edition, Clarendon Press, Oxford, UK.