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CORPORATE Finance REVIEW

Market Returns and Risk

What Do Investors Really Know

Quantifying Counterparty Exposure on Derivatives

Structuring Smart Real Estate Deals

SUSTAINABILITY AND ESG REPORTING FRAMEWORKS: ISSUERS HAVE GAAP AND IFRS FOR REPORTING FINANCIALS—WHAT ABOUT REPORTING FOR INTANGIBLES AND NON-FINANCIALS?

In the United States corporate issuers and investors have the familiar GAAP to rely on for their reporting, covering financial aspects of the publicly-owned enterprise; in Europe, the UK, and in many others nations there are International Financial Reporting Standards (IFRS). Increasingly, multinationals, or more properly large *transnational* enterprises, may use a combination of the two accounting and financial reporting systems.

U.S. standard-setters for Generally-Accepted Accounting Principles (GAAP)—by congressional action as part of Sarbanes-Oxley legislation, the Financial Accounting Standards Board (FASB), and the Securities & Exchange Commission (SEC)—are publicly committed to ongoing deliberations on harmonization of the two systems at some point. The differences have generally been described as being a rules-based (USA) or principles-based approach (non-USA) to corporate financial reporting (although accounting experts and the FASB point out that in practice there are many similarities). Whatever system is used, the movement toward adoption of extensible Business Reporting Language (XBRL) has become more universal. (Large-cap U.S. firms are now reporting in XBRL, as EU and UK have done previous to the U.S. adoption.) That may help narrow the financial accounting systems gap until more "harmonization" becomes reality.

We might here say that the traditional financial reporting aspects for most of the world's publicly-traded enterprises with a diverse body of shareowners relies on traditional approaches with well-established standard setters and well-settled methods of establishing new rules under either system to accommodate changes in business practices. (Think of the changes needed as computer software emerged as distinct service/product category.)

Non-financial / intangibles reporting

Until now, we've been addressing the methods used for traditional financial disclosure and formal reporting of the state-of-the-enterprise to shareholders and regulatory agencies. While the two reporting systems–GAAP and IFRS–have their differences and many similarities, as more investors and stakeholders emphasize the importance of *non-financial* and *intangible* aspects of the business, an element of what many observers describe as part of the *new normal* of the capital markets, GAAP and IFRS fall short of what may be needed to satisfy investment demands or expectations for more information.

The players in *new normal* of the capital markets include a growing number of analysts, asset owners, and professional money managers focusing on new methodologies; new analytical models; new frameworks and systems for analyzing, evaluating, and valuing corpo-

HANK BOERNER *is chairman of the Governance & Accountability Institute and is a full-time "watcher-of-the-watchers," the third parties and investors that watch and monitor corporate key performance indicators in "ESG." He may be reached at hboerner@ga-institute.com.*

rate equities and debt issues *beyond* the financials. For a growing number of analysts and shareowners what had been considered non-financial and intangible are in fact of importance in outcomes that *are* financial and tangible. These factors impact corporate reputation, share valuation, cost of capital, and even access to capital. So, these are increasingly important to investors, taking evaluation and analysis of a corporation well beyond the financial.

According to the U.S. investor trade group Social Investment Forum, in its latest survey of institutional investors across a spectrum of categories charted, US$3.1 trillion in Assets Under Management (AUM) at the end of 2010 qualified as being "sustainable and responsible" investments of some kind—"SRI." That is, $1 in every $8 invested in U.S. capital markets. The total amount increased AUM from $2.7 trillion in the survey taken two years earlier. Despite the overall market downturn (2007-2009), and troubled American economy, investors migrated to SRI investing—a "flight to safety," some SRI advocates explain.

The SRI AUM in the United Kingdom and the European Union is smaller in total sum than in the U.S., but perhaps is even more significant to many non-U.S. investors. The European Union is considering mandating certain aspects of non-financial reporting by domestic corporations, which would create a very different system of overall disclosure and reporting than that of the U.S. However, a series of small steps in the same direction have been taken by SEC, as it reminded boards of responsibility to oversee risk and then categorized climate change as one of the important risks for U.S. public companies to report.

Sustainable and responsible investing frameworks

The SRI frameworks are known by various names perhaps not always recognized by mainstream investors and by corporate boards and executives: *Triple Bottom Line* (also known as total cost accounting for "People, Planet, Profit"); "ESG" (key corporate performance indicators for environmental, social issues and corporate governance); "EES" (economic, environment and social accounting); or *Sustainability*. The response from the corporate side is often creation and implementation of *Corporate Responsibility* (CR) strategies, initiatives, and programs. These CR programs are usually welcomed by investors if substantive, encompassing the entire enterprise, with expanded disclosure and transparency on key metrics, and not "greenwashing" or simply marketing or public relations efforts.

Two years ago, a survey of EU financial analysts and investors plumbed the views of professionals who are familiar with the various approaches, and the preferences were two: ***ESG*** and ***Sustainability,*** with a 50-50 split in responses to define the new frameworks. It is important to note, as one begins the journey of learning more about ESG and Sustainability [of importance to investors], is that what mainstream investors, and corporate managers have long viewed as being *non-financial, intangible* factors related to valuation of the enterprise. For a growing number of asset owners and managers, these are very tangible considerations with measurable financial impacts. The effects of impacts are being thoroughly analyzed, modeled, and backtested by a growing universe of third party service providers who begin with the *financials* and then add the important layers of the "E, S and G" factors to the framework for evaluating companies.

US corporate questionnaire fatigue

Most U.S. large-cap and an increasing number of mid- and even-small cap companies are now regularly receiving formal inquiries and surveys from third party research and analytics service providers focused on ESG performance indicators. The result can be a culture shock. U.S. companies are well-versed in the arcana of environmental reporting—what is required under the *Clean Air Act,* the *Clean Water Act, Toxic Release Inventory* (releases to the environment) regulations, and so on. What the ESG researchers request of corporate reporters is often much more than that, including

details of corporate plans to reduce emissions, energy use, and implementation of alternative energy sources and more recently, reduction of water use. (One use of such inquiry is the annual *Newsweek* ranking of "100 greenest companies in the USA," in collaboration with Trucost, which maintains the largest database of environmental and emissions data.)

The inquiries and survey questions can be considerable, and require commitment of many hours to assemble and analyze the data to be communicated in response. U.S. companies that we have spoken to have varied responses. Some managers ignore the third party requests; some answer partially (being careful not to go beyond what is required reporting to U.S. regulators); some engage with the third parties and negotiate their way through the complexity of the requests. Some managers work at meeting shareholder expectations with robust, expanded reporting. *What gets measured gets managed,* as the expression goes, and for companies with progressive management focused on sustainability, also gets *reported.*

A common complaint of U.S. and European companies and investors is that there is no standard for ESG / Sustainability reporting, no common framework or systematic approach to respond to, as is the case with investor or analyst or internal requests for financial information (the GAAP or IFRS systems provide the common ground for engagement with financial analysts and asset owners or their managers).

CERES–Pioneering responsibility reporting

As the acceptance and embrace of Sustainable and Responsible Investment (SRI) broadened in the late-1970s and through the 1980s among more institutional investors, the need for more standardized reporting became an important topic of conversation. After the *Exxon Valdez* oil tanker spill in Alaska's Prince William Sound (1989), within six months a group of investors, environmental organizations, social issues advocates, public interest groups and a few corporations (such as Ben & Jerry's) created the not-for-profit, Boston-based CERES–the Coalition for Environmentally Responsible Economies.

Early on CERES created the *Ceres Principles,* a 10-point code of corporate environmental conduct that U.S. companies were asked to sign on to and [to] report periodically on their environmental management activities. The first *Fortune 500* to endorse the principles was Sun Oil Company (Sunoco) in 1993; others followed, including General Motors (which adopted its own code) and a dozen other F-500s. Signatories pledged to continuous improvement, dialogue with investors and stakeholders, and more public (and systematic) reporting. More than 50 companies have adopted Ceres Principles, which include energy conservation, sustainable use of natural resources, reduction and disposal of waste, disclosure, audits and reports, and more.

By 1997-1998, the concept of a *global* reporting initiative evolved; in 1999 the United National Environmental Programme (UNEP) and CERES collaborated to draft the first version of "Global Reporting Initiative Sustainability Reporting," which became a separate organization in 2001 and the first generation of global reporting principles were published. The draft of the third generation (G-3) GRI Principles was published in 2006 and implemented soon after (these are the current Principles that organizations report against). (Note the fourth generation drafting is underway, to be completed and published by 2013.).

The CERES stated Mission: *Integrating sustainability into the capital markets for the health of the planet and its people.* CERES and the UN worked to bring together 500+ U.S. and EU investors, financial markets interests, and corporate leaders to address the growing risk of climate change. A group of 28 U.S. and European investors have agreed to a 10-point action plan on climate change calling for improved analysis, disclosure, and corporate action by companies, Wall Street interests. CERES organized and manages the Investor Network on Climate Risk (INCR), 70 leading institutional investors with Assets Under

Management of US$7 trillion to coordinate action on climate change issues.

The Global Reporting Initiative–GRI

Coming out of the UN-CERES collaboration, and dialogue at global conferences and United Nations summits, sizable stakeholders agreed to the concept of a *global* framework for environmental performance reporting–and more. This resulted, as explained, in the GRI, a foundation created under the auspices of the UN and advancing groundbreaking decades-long work of the U.S.-based CERES. The "G3" Sustainability Reporting Framework is now used by 1300+ corporations, governments, social sector and other organizations to report against generally-accepted *sustainability* or *ESG* principles. The GRI is based in Amsterdam, the Netherlands; a New York City office was opened recently and the "Focal Point USA" project was launched to broaden U.S. corporate participation in GRI reporting. (The office is headed by Mike Wallace, an American with long experience in environmental management and reporting; and is located at The Conference Board offices.) Focal Point USA was premiered in cooperation with the New York Stock Exchange at an event at the Exchange in January 2011.

GRI sustainability reporting principles

The third generation ("G3") sustainability reporting principles–a critical part of the global ESG reporting framework–were published in 2006. The overarching elements of GRI sustainability reporting include *materiality, stakeholder inclusiveness, sustainability context, and completeness.* The reporting organization–again, this is all voluntary–decides on what is material, and the completeness (or not) of the story, the narrative that is being told through the GRI approach.

The GRI "Standard Disclosures–Key Performance Indicators" cover six categories: Environmental; Human Rights; Labor Practices and Decent Work; Society; Product Responsibility; and Economic. These are comprehensive reporting schematics, each covering specific elements of corporate activities. For example, in the "Labor Practices and Decent Work" category, companies may report on total workforce by employment type, contract and region; labor-management relations; occupational health and safety issues; workforce training and education; diversity and equal employment opportunities. (Companies with good stories to tell find the GRI a suitable global framework for such reporting.)

The GRI process is organic; with stakeholder engagement Sector Supplements developed (for unique reporting requirements of industries) in collaboration with industry partners; and, National Annexes (for reporting unique to a country).

This is just a small part of the overall Sustainability Reporting Framework that constitutes the Global Reporting Initiatives. Corporations can report (1) according to the GRI Principles; (2) to the GRI by filing reports with the organization; (3) self-grade the report; (4) have a third party review and attest to the report. Some U.S. companies publish reports that say the firm is following the GRI Principles and offer little in the way of data (as example) for environmental performance and improvements in reducing energy consumption or reducing waste. Other U.S. companies offer more complete emissions data and performance improvements.

U.S. companies can become "Organization Stakeholders" (OS) to support the work of the GRI. These currently include: Accenture, Baxter International, Bloomberg, CRD Analytics, Dell, Ernst & Young, Ford, Green Mountain Coffee Roasters, Newmont Mining, Nike, PWC, SAS, State Street, Trillium Asset Management, and UPS. For the full list of members see *www.globalreporting.org/AboutGRI/JoinGRI.* There is much more for corporate financial managers to absorb within the GRI framework. The GRI system of ESG / Sustainability reporting is becoming a *de facto* standard for many public companies. More information is available at: *www.globalreporting.org.* The USA coordinator, Mike Wallace, is available for information at: *wallace@globalreporting.org.* ■