

*Journal of***APPLIED CORPORATE FINANCE****In This Issue: Sustainability and Shareholder Value**

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Models of Best Practice in Integrated Reporting 2015

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In March of this year (2015), we reviewed the reports of 25 multinational companies that participated in the International Integrated Reporting Council's (IIRC's) Pilot Programme Business Network.¹ (See Table 1 for a list.²) Pilot Programme companies worked as a network of peer group organizations to exchange knowledge about integrated reporting. These 25 randomly selected reports were among the first to be published since the IIRC International <IR>³ Framework was released in December 2013. The publication of these reports gave us the opportunity to assess the extent to, as well as the effectiveness with which the companies have made use of the framework. Our aim in this article is to provide a brief review of the approaches and quality of this first batch of reports, and a sampling of best practices.

We began our review with the assumption that there are three distinguishing marks of a truly integrated report—one that is not simply the outcome of combining two separately conceived and prepared reports: (1) an explanation of a company's strategy for creating value and how it uses and affects the "six capitals" (Financial, Manufactured, Intellectual, Human, Social and relationship, and Natural)⁴; (2) a clear and detailed explanation of the relationships between financial and nonfinancial performance; and (3) identification and effective presentation of the material risks and opportunities facing the company...For this reason, instead of attempting to assess the quality of entire integrated reports, we looked for examples of best practice by focusing on these three related elements: (1) Strategic focus; (2) "Connectivity of information"; and (3) Materiality.

To provide some objective basis for our assessments and choices, we established benchmarks for disclosures using the Guiding Principles and Contents Elements in the "International <IR> Framework" as well as suggestions regarding prioritization of stakeholders and the role of the board in the materiality process in our recently published book,

The Integrated Reporting Movement.⁵ By highlighting these requirements (summarized in Table 2) and the ways in which companies have attempted to satisfy them, we aim to provide a sense of how companies are doing as they apply the <IR> Framework to their integrated reports in 2015.

Evaluating Strategic Focus

As we argued in our book, "A sustainable strategy is one that enables a company to create value for its shareholders over the long term while contributing to a sustainable society."⁶ A high-quality integrated report not only explains a company's sustainable strategy, but also it establishes board and management accountability for creating value over the long term for all stakeholders.

While companies explained their sustainable business strategies with varying degrees of thoroughness, SASOL, BASF, and AkzoNobel provided exemplary qualitative links between their overall strategies and the roles played by ESG factors in those strategies. At the same time, the reports of Crown Estate, Eskom, and Aegon were all distinguished by memorable uses of graphics to accomplish the same objectives.

One trend that emerged in our analysis was the tendency of companies, particularly manufacturers, to connect their integrated strategy to product innovation, with specific changes in their development pipelines that reflect their goal of developing and marketing products that consume fewer resources. Meanwhile, companies that do not produce physical products, such as Aegon, the Dutch insurer and asset manager, linked their strategies to actions that leave their communities in better shape in terms of developing human capital or helping customers secure their financial future. In all cases, the companies left no question about the reason for including "nonfinancial" variables in their discussion of business strategy: The measurement and reporting of nonfinancial factors were essential to a fuller understanding of the businesses' continued ability to operate in its context.

1. The IIRC Pilot Programme Business Network came to an end in September 2014 after three years of developing and piloting the principles and concepts behind integrated reporting. In its place, the IIRC established a business network of organizations committed to the adoption of integrated reporting. <http://integratedreporting.org/ir-networks/ir-business-network/>, accessed May 2015.

2. Not all participants in the Pilot Programme, including some of those identified in Table 1, published an integrated report. Some continued to issue separate annual financial and sustainability reports, while others simply combined their financial and sustainability reports into a single document.

3. The authors use the International Integrated Reporting Council convention "<IR>" to denote the term "integrated reporting."

4. International Integrated Reporting Council. "The International <IR> Framework," pp. 11-12.

5. Robert G. Eccles, Michael P. Krzus, and Sydney Ribot. *The Integrated Reporting Movement: Meaning, Momentum, Motives and Materiality*, New York: John Wiley & Sons, Inc., 2014.

6. Ibid. p. 80.

Table 1 **Reports Reviewed**

Company	Country	Industry
AEGON NV	Netherlands	Financial services
AkzoNobel N.V.	Netherlands	Chemicals
ARM Holdings plc	UK	Technology hardware & equipment
BAM Group	Netherlands	Construction & materials
bankmecu Limited	Australia	Banks
BASF SE	Germany	Chemicals
BRF S.A.	Brazil	Food
Clorox Company	USA	Chemicals
Coca-Cola Company	USA	Beverages
Crown Estate	UK	Real Estate Management
Diesel & Motor Engineering PLC	Sri Lanka	Industrial engineering
Eskom Holdings SOC Limited	South Africa	Electricity
Kirloskar Brothers Limited	India	Manufacturing
Marks and Spencer Group plc	UK	General retailers
Microsoft Corporation	USA	Software & computer services
National Australia Bank Limited	Australia	Banks
Novo Nordisk	Denmark	Pharmaceuticals & biotechnology
Sainsbury's	UK	Food retail
SASOL	South Africa	Chemicals
Slater & Gordon Lawyers	Australia	Legal Services
Stockland	Australia	Real estate investment & services
STRATE	South Africa	Financial services
Takeda Pharmaceutical Company Limited	Japan	Pharmaceuticals & biotechnology
Tata Steel	India	Steel producers
Telefónica S.A.	Spain	Telecommunications

Table 2 **Assessment Criteria**

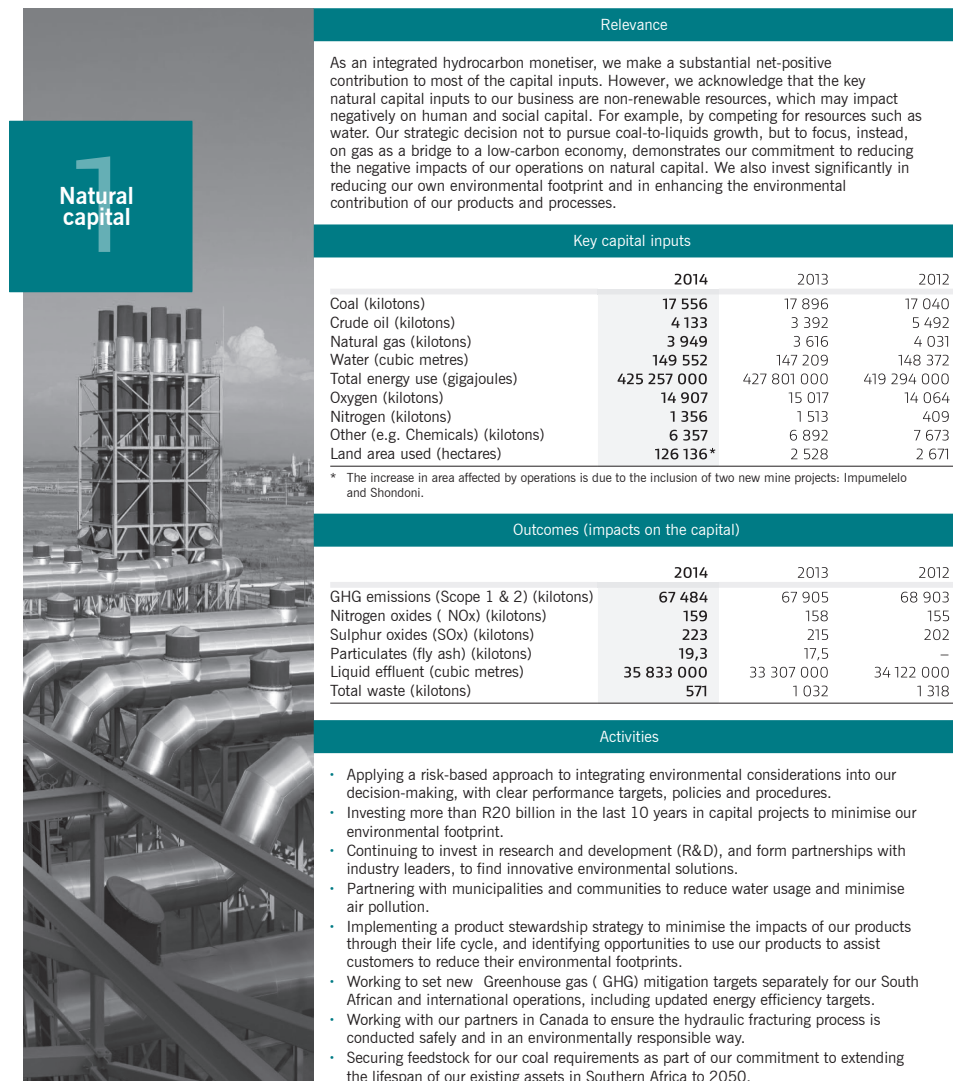
Criteria	Reference
<i>Strategic focus</i>	
Explain the time frames (short-, medium-, and long-term) associated with strategic objectives.	<IR> Framework 4.27 and 4.28
Explain the strategic importance of material risks and opportunities in the discussion of business strategy.	<IR> Framework 4.29.
Explain how the company plans to use “the capitals” and the impact of business activities on the capitals.)	<IR> Framework 3.3.
<i>Connectivity of information</i>	
Explain how financial and nonfinancial performance impact each other.	<IR> Framework 3.8 and 4.32.
Link and explain the relationships between <IR> Framework Content Elements.	<IR> Framework 3.6-.9
<i>Materiality</i>	
Explain material risks and opportunities in greater detail, especially in terms of known or potential effects on financial, environmental, social, or governance performance.	<IR> Framework 3.17, 3.18, and 3.21-.23.
Identify the time frames (short-, medium-, and long-term) associated with material risks and opportunities.	<IR> Framework 3.18 and 3.24-.27.
Prioritize material risks and opportunities based on their magnitude/importance.	<IR> Framework 3.18 and 3.28.
Prioritize the perspectives of stakeholders consulted.	<i>The Integrated Reporting Movement</i> , Chapter 5. Eccles, Krzus, and Ribot, 2014.
Explain the role of the board of directors in the materiality process.	<i>The Integrated Reporting Movement</i> , Chapters 5 and 6. Eccles, Krzus, and Ribot, 2014. <IR> Framework 4.42.

Figure 1 **SASOL's Use of Natural Capital**

Our value creation scorecard

Managing the critical capital input we require

The resources and relationships that are critical to our ability to create value are all interdependent, which, at times, necessitate certain trade-offs between them. In managing these trade-offs, we aim to minimise our negative impacts on the capital inputs and maximise positive outcomes, in the interests of all our stakeholders.



Source: SASOL. *Annual Integrated Report 2014*, p.10.

“The integrated report of SASOL, a South African integrated chemical and energy company, explained its main value proposition as doing more with less: “Our unique value proposition...remains our ability to convert coal and natural gas into high-quality fuels and chemicals, and low-carbon electric-ity, using our proprietary technologies.”⁷ The report explains

not only what the company is doing to meet the challenges of nonrenewable resources, but *how* and *why* it is in their inter-ests to use fewer resources to make their products. As a result, readers can readily see that company efforts to reduce emissions and increase productivity come from a strategic vantage point for shareholders as well as for society.

7. SASOL. *Annual Integrated Report 2014*. p.26.

Figure 2 Clorox Business Value Drivers¹⁰



Source: The Clorox Company. 2014 *Integrated Annual Report*. p. 14

Because companies have different business models, explaining *how* and *why* something is reported on is just as important as explaining *what* is reported. As has been mentioned, the IIRC's six capitals concept can help companies do this. In one of the most explicit deployments of this <IR> Framework, SASOL breaks down its "value creation scorecard" into the six capitals to show relevant risks and opportunities and how the company manages the trade-offs between financial and nonfinancial factors. Figure 1, for example, presents a section of SASOL's integrated report that describes the company's most important initiatives for protecting the environment and the company's "natural capital" as well as its own longer-run profitability and value.

Among U.S. companies, Clorox has published an integrated report that does a good job of presenting its strategy for use of the six capitals. Although the company's report does not refer explicitly to them in the manner envisioned by

the <IR> Framework, it features a simple one-page graphic with explanatory text (shown in Figure 2) that captures most of the same concepts. For example, in a section called "Operating Context: Business Value Drivers," the company discusses its management of "Human Capital," the goal of which is to develop and retain "talented and engaged employees." Another section of its report, "Superior brand-building capability: 3D innovation" and Advantaged product portfolio," corresponds to the IIRC's concept of "Intellectual Capital." A section titled "Financial discipline and strong cash flow" involves the management of "Financial Capital." Further, the IIRC's concept of "Social and relationship Capital" can be seen under the value driver "Our Relationships."⁸ Finally, the section of the report called "Our Impact" covers some, if not all, aspects of "Natural Capital."⁹

By contrast, AkzoNobel, the Dutch manufacturer of

8. The Clorox Company. 2014 *Integrated Annual Report*. p. 14.

9. Ibid. pp. 32-34.

plastics and elastomers, makes no direct reference to the capitals in its report. Instead the main emphasis falls on the role of product innovation in its strategy for value creation. Because over 60% of the company's revenue comes from products and services that are linked to the urban environment,¹¹ it is in AkzoNobel's interests to make the world's cities more sustainable. To this end, AkzoNobel created a barrier coating that made possible the world's first fully compostable and recyclable paper cup for cold drinks as well as a precursor critical to the development of LED lights. The goal, as its report reads, is a "future-proof raw material portfolio."¹²

Given the pressure faced by companies that depend on diminishing natural resources, it is natural for AkzoNobel to want to get more value from fewer resources by optimizing its supply chain. As part of this strategy, the company is investing to reduce its carbon footprint (and eventually its total energy costs), converting biomass, and obtaining algae-based oils from suppliers to replace petroleum and palm oil derivatives.¹³ The company also describes how closed-loop processes involving pulp-bleaching chemicals will lead to less waste going to landfill.¹⁴

The report by the Germany chemical company BASF describes its strategy as long-term and focused on three main concerns: the environment and climate change; food and nutrition; and quality of life. In addressing these concerns, the company claims to be guided by the following three questions: (1) What will the cities of the future look like? (2) Where will the energy we need come from? (3) How can everyone have access to healthy food?¹⁵ Their strategy intends to help answer those questions by choosing the sustainable option—for example, by securing their own energy supply for houses and the loss-free transmission of electricity through better technology. The Verbund¹⁶ system allows the company to recycle energy within their production ecosystem (though no numbers were given to indicate the amount of the energy savings from enabling one unit to use heat released by another). The report also mentions the importance of keeping farmland arable for future generations to meet society's rising food expectations—a challenge that has led the company to invest heavily in extending its development pipeline to biological solutions.¹⁷ In 2014, BASF invested €511 million in research and development in its Crop Protection division, an investment that represents about 9% of the division's sales.

Like AkzoNobel, the company has placed heavy emphasis on product innovation. For example, by 2020, the company aims to generate as much as 30 billion euros of their sales—

and €7 billion of their EBITDA—from products that have been on the market for less than ten years.

The BASF report sums up its overall strategic thinking as follows:

As the world's leading chemical company, we combine economic success, environmental protection and social responsibility. We have recognized sustainability as a significant driver for growth. By integrating sustainability considerations into our decision-making processes, we optimize our business and contribute to long-term economic success. We accomplish this by, for example, embedding sustainability into our organization with clearly defined responsibilities.

Our sustainability management has three duties: We want to identify significant topics early on, take advantage of business opportunities, and minimize risks. We are assisted in this endeavor by constant, trust-based exchange with our stakeholders...¹⁸

As this last sentence suggests, BASF connects its big-picture strategy to major sustainability concerns and identifies its method for determining which social concerns were the most urgent—namely, intensive stakeholder engagement. While we do not identify stakeholder engagement as one of the three most distinctive features of an integrated report for this article, we acknowledge such engagement as a critical step in determining the "materiality" of a given risk or opportunity.

Finally, as we noted earlier, a number of reports do an excellent job of using graphics to communicate their sustainable value creation strategies and to convey their sense of the relationships among nonfinancial and financial objectives. Among such reports are those of Eskom, a South African electricity public utility, and the Crown Estate, a property portfolio owned by the Crown in the United Kingdom. But perhaps the most effective of all is a report by Aegon N.V., a Dutch multinational life insurance, pension, and asset management company. The first 20 pages of the company's 2014 Annual Review use a mix of text and graphics to present its integrated value creation strategy. Starting with an easy-to-understand table that explains their business model in four steps,¹⁹ the report then provides a one-page table titled "Our ambitions and targets"²⁰ (shown in Figure 3) that identifies four strategic objectives and then answers the following questions for each.

- What does this objective involve?
- What performance indicators do we use?

10. This image captures only a portion of the graphic published by Clorox.

11. AkzoNobel launched their Human Cities initiative because a significant portion of revenues is connected to cities. AkzoNobel. *Report 14*, "Human Cities initiative," pp. 10-24.

12. AkzoNobel. p. 28.

13. Ibid. p. 29.

14. Ibid. p. 42.

15. BASF. *Report 2014*, unnumbered page.

16. Verbund is both a principle and a system. It enables BASF to add value through efficient use of resources; Verbund systems are in place for production, employees, customers, and technology. BASF. Company/About Us, Strategy & Organization, Verbund, <https://www.basf.com/en/company/about-us/strategy-and-organization/verbund.html>, accessed June 2015.




17. BASF. p. 37.

18. Ibid. p. 29.

19. Aegon. *2014 Review*. pp. 21-22.

20. Ibid. p. 22.

Figure 3 Aegon Strategic Objectives²²

Strategic objectives	Optimize our portfolio 	Strengthen customer loyalty 	Pursue operational excellence 
What does this objective involve?	Making sure we invest in areas that offer strong growth and attractive returns.	Improving our service to customers, extending our range of products and investing in new distribution.	Reducing costs, encouraging innovation and making more effective use of our resources.
What performance indicators do we use?	<ul style="list-style-type: none"> • % of earnings from fees • % of sales direct to customer¹ 	<ul style="list-style-type: none"> • % of Aegon businesses using the Net Promoter Score (NPS) to measure customer loyalty • NPS performance (benchmarked vs. peers) 	<ul style="list-style-type: none"> • Ratio of costs to assets • Ratio of costs to earnings
Why did we choose these indicators? How do they link to our material issues?	We want a better balance in our earnings. We want to earn more relatively from fees, and reduce our dependence on credit spreads.	NPS will help drive improvements in both products and customer service, helping us adapt to changes in our markets and ensuring that customers stay with us for longer.	We want to improve our efficiency; these ratios will help us track our progress. Being more efficient will help us adapt more quickly to greater competition and the increase we're seeing in financial services regulation.
What material issues do they link to?	<ul style="list-style-type: none"> • Persistently low interest rates • Changing capital requirements • Increased use of new technology 	<ul style="list-style-type: none"> • Customer service & product performance • Changing demographics • Increased use of new technology 	<ul style="list-style-type: none"> • Increased use of new technology • Increased regulation
How did we perform in 2014?	Our target is to double fee based income to 30%-35% of our underlying earnings before tax by 2015. In 2014, the figure was 39%, so we're ahead of schedule. Our direct sales ¹ – online, via tied agents and through affinity and worksite marketing – accounted for 21% of total sales last year, up from 12% in 2013.	Ninety-nine percent ² of our businesses worldwide now use NPS to measure customer loyalty. We benchmark our NPS performance against peers. To meet our target of being the most recommended, we want to be in the top 25% in each of our chosen markets. Last year, most of our benchmarked businesses ranked in the second or third quartile. Please see page 31 for further details.	We don't have a target in this area, but we strive for improvements year on year. In 2014, our costs:earnings ratio improved slightly to 58% ³ (from 59% the previous year). Costs:assets was unchanged at 0.6%.

1. Based on budgeted sales.

2. Weighted by IFRS capital allocation.

3. Adjusted for model and assumption updates. Without these adjustments, our cost: earnings ratio for 2014 would have totaled 61%.

• Why did we choose these indicators? How do they link to our material issues?

• What material issues do they link to?

• How did we perform in 2014?²¹

Then follows a section called “How we create and share

value”²³ in which the company continues its use of graphics and text to show how it creates value for its customers and other stakeholders. Aegon's value chain graphic²⁴ consists of two pages that focus on three of the six capitals: Financial, Human, and Social and relationship. The aim of this section is

21. Ibid.

22. This image captures only a portion of the graphic published by Aegon.

23. Ibid. pp. 27-45.

24. Ibid. pp. 28-29.

Figure 4 **Aegon Financial and Nonfinancial Performance Links**³⁴



Revenue

- + With aging, demand for pensions and other long-term savings products should increase. New markets in Asia, Latin America and Central & Eastern Europe are also opening up.
- + Because of new technologies, there'll be more frequent contact with customers. As a result, insurers will know their customers better – which should lead to more effective products and a more consistent customer experience.
- + Aging, new technologies and changes in regulation may open up opportunities – to develop new products, improve existing ones, or reach out to new customer groups.
- + With new technology, products can be improved so they're easier to understand, and more suitable for online or mobile platforms.
- In some cases, changes in regulations could reduce demand for certain products and services.
- Solvency II also has implications for the kind of products that might be offered.
- Demand from younger consumers may decrease if insurers don't respond quickly enough to changes in customer behavior.



Earnings

- + Increased use of technology should open up more distribution capacity, and push down operating costs. Increased demand, meanwhile, should flow through to increased earnings.
- + Our scale – and diversity – makes it easier for us to cope with an increasingly complex operating environment.
- With new technologies, there's increased risk of 'commoditization' and increased competition, which could mean lower prices and narrower margins. Some products – even some markets – could become unprofitable. Products may have to be modified, or even discontinued.
- Because of low interest rates, returns on some of our investments will go down. Margins may be squeezed, especially on products that offer guaranteed returns.

Source: Aegon. 2014 Review, p. 18

to provide more information to help readers understand how the company, as a provider of financial services, creates value as (1) an employer, (2) an investor, (3) a participant in local communities, and, more generally, as (4) a socially responsible company. And, indeed, the report ends up listing 18 ways that the company aims to create social as well as shareholder value, such as putting customers at the center of what they do, helping those who don't have easy access to insurance, making the companies they invest in accountable, and supporting local communities.

The company's discussion of value creation as a socially responsible company closes with a table summarizing the internal policies and procedures that guide managerial decision-making and ensure that decisions are in the long-term interests of Aegon and its stakeholders. The table identifies policies and procedures that are available online.²⁵

Connectivity of Information

In the absence of statements (or graphics) that show the relationships between financial and nonfinancial performance, we view reports not as “integrated,” but as “combined.” In making that determination, we look for evidence of the “Connectivity of information,” that is, for clear indications that companies have thought about how financial and nonfinancial performance affect each other. Such interdependencies can be

explained in a variety of ways, but we view as essential some discussion of the relationships among the IIRC's Eight Content Elements—Organizational overview and external environment, Governance, Business model, Risks and opportunities, Strategy and resource allocation, Performance, Outlook, and Basis of preparation and presentation.²⁶ These Content Elements should be presented in a way that shows their connection to the context in which the business operates and provides a clear explanation of the business's “system of transforming inputs, through its business activities, into outputs and outcomes that aim to fulfill the organization's strategic purposes and creative value over the short-, medium-, and long-term.”²⁷

For example, when explaining how its sustainability efforts affect revenues, the Danish pharmaceutical company, Novo Nordisk, provides clear quantitative information about the interdependencies between energy consumption and revenues:

*In 2014, 2,556,000 GJ [gigajoules] energy and 2,959,000 m³ water were consumed at production sites around the world. Energy consumption decreased by 1% despite increased production as a result of the focus on optimisations in the production processes.*²⁸

*Since 2004, Novo Nordisk has reduced CO₂ emissions from energy consumption for production by 97,000 tons, equal to 45%. In the same period, the company has grown by 206% as measured in sales.*²⁹

25. Ibid. p. 44.

26. <IR> Framework. pp. 24-29.

27. Ibid. p. 24.

28. Novo Nordisk, annual report 2104. p.13.

29. Ibid.

The main drivers cited for such reductions in energy use were process optimizations, conversion to renewable energy supplies, and more than 700 energy-saving projects, which have led to a reduction in CO₂ emissions of 45,000 tons annually. “Novo Nordisk is now expanding its scope of reporting to include CO₂ emissions from business flights and leased company cars. In 2014, business flights resulted in estimated emissions of CO₂ of 68,000 tons, which is 6% less than in 2013.”³⁰ All is the result of a focus on keeping costs low.

By comparison, the high-end English retailer Marks & Spencer did not provide explicit detail about the effects on business performance of any of the six capitals. Nevertheless, its report did declare that its “Plan A”—the name given to its collective sustainability initiatives—delivered a net benefit of £145 million, which was invested back into the business.³¹ Two examples of the company’s social “investments” cited in the report were the 1.5 days’ worth of training it now provides its customer assistants and the company’s the total cash tax contribution to the UK Exchequer.³²

Aegon took a different approach by providing a clear one-page table (reprinted in part in Figure 4) that explains the potential positive and negative impacts of each material issue—changing demographics, increasing financial service regulation, emerging technologies, new capital rules, and low interest rates—on its financial performance.³³ As can be seen in the Figure 4, Aegon identifies the opening of new markets as a potentially positive result of changing demographics, while changes in technology creates the risk of a commoditization of products and services and increased competition.

Materiality

As defined in the <IR> Framework, “materiality” as a guiding principle refers to “any real risks (whether they be in the short, medium or long term) that are fundamental to the ongoing ability of the organization to create value and that could have extreme consequences...even when the probability of their occurrence might be considered quite small.”³⁴ Part and parcel of this is explaining how a company determines materiality while providing management’s view of the resulting exposure or opportunity.

When evaluating the effectiveness with which a company explained its view of materiality, we considered five factors to be of primary importance. We determined whether, and in how much detail, the report explains material risks and opportunities in terms of their known or potential effects on both financial and ESG performance, and whether it provides specific time frames (short-, medium-, and long-

term) for each. The extent to which material risks and opportunities were clearly prioritized based on magnitude or importance was an important consideration. We also asked questions like the following: How transparent are companies about their stakeholder engagement process? Do they clearly prioritize the stakeholders consulted or explain why a certain stakeholder group is given more weight than another? Because companies operate with different business models and therefore have different priorities, showing *how* stakeholders are weighted can be as important as *what* issues come to the fore as material. Finally, we looked for whether the role of the board of directors—those charged with governance—was clearly indicated in the materiality determination process.

While companies often referred to stakeholders or “society” in general, few clearly prioritized the perspectives of those stakeholders consulted or explained how they went about determining which were the most relevant. And the same was true of the issues selected. Tata Steel, for example, mentioned that stakeholder engagement informed the preparation of a materiality map, but little information was provided about how these analyses were conducted.³⁶ And although companies often mentioned risks, such risks were rarely tied to corporate goals, such as targeted reductions of carbon emissions. Projections of ESG performance and forward-looking information of any kind were rare.

When it came to identifying the extent of the Board’s involvement in and commitment to the materiality determination process, SASOL was one of very few companies to explicitly classify integrated risks as the responsibility of the Board or to set specific time frames for their objectives.³⁷ Another such case is that of Crown Estate, the manager and developer of property owned by the UK Crown, whose materiality narrative in the Strategic Report section of its annual report begins with a discussion of “Key factors affecting our performance.”³⁸ In the preamble to that section, the report states that the Management Board, which is chaired by the CEO, reviews material issues annually.³⁹ The organization defines material issues as “factors that could potentially influence our ability to deliver our Strategic objectives.”⁴⁰

Finally, we applaud Marks & Spencer’s treatment of materiality, which was unique in that its annual report actually cites the sustainability-related responsibilities of each director of the board and their direct link to compensation (shown in Figure 5).⁴¹

Also unusual, and highly commendable in our view, BASF’s report provided a clear account of how materiality was deter-

30. Ibid.

31. Marks & Spencer. *Plan A Report 2014*, pp. 6 and 25.

32. Marks & Spencer. *Annual report and financial statements 2014*, p. 32.

33. Aegon. p. 18.

34. This image captures only a portion of the graphic published by Aegon.

35. <IR> Framework p. 27.

36. Tata Steel. *Annual Report 2013-2014*, p. 125.

37. SASOL. p. 60.

38. The Crown Estate. *Annual Review and Accounts 2014*, pp. 46-47.

39. Ibid.

40. Ibid.

41. Marks & Spencer. *Annual report and financial statements 2014*, p. 64.

Figure 5 Marks & Spencer Links Between Director Remuneration and Plan A

Report on Directors' remuneration continued

Annual Bonus Scheme for 2013/14 (audited)

In 2013/14, 60% of the executive directors' bonus was based on PBT performance and 40% was based on the achievement of four individual objectives, independent of PBT (but subject to achieving a 'threshold' PBT target). As detailed below, no payments were made in relation to financial or individual objectives for 2013/14.

PBT objective

PBT targets were set taking into account the Company's operating plan, external forecasts for the retail sector and analysts' profit forecasts. Targets were designed to be stretching in order to drive desired behaviours and increase motivation and focus. The final PBT performance was £623m which was below the threshold target set by the Committee. As a result, no bonus was payable under the PBT element of the Scheme. The Committee has a robust process in place to ensure that profit targets set are stretching. The Committee believes that the specific targets are commercially sensitive and therefore is unable to disclose them.

Individual objectives

Each director had four individual objectives for 2013/14, together accounting for 40% of the total bonus. These objectives reflected key areas of focus for the business and those relevant to each director's business area to ensure the strategic success of the Company. Two objectives were 'collective' i.e. individual targets set for each director under shared Plan A and costs objectives, encouraging a common focus and collaboration across the senior team. The remaining two objectives were business area individual objectives related to specific programmes to each director. The table below details some of these individual objectives.

Examples of individual objectives – 2013/14		
	Collective (Plan A and costs)	Individual (business area)
Marc Bolland	– UK operating costs – 'Make Your Mark' youth employment programme	– Senior leadership capability
Patrick Bousquet-Chavanne	– Marketing operating plan costs – Garment shwopping volumes	– New in-store concepts
John Dixon	– GM gross margin – GM products with Plan A attributes	– GM market share
Steve Rowe	– Food gross margin – Food products with Plan A attributes	– In-store food availability
Alan Stewart	– Finance, IT and logistics operating plan costs – Carbon reduction in logistics	– New distribution centre efficiency
Laura Wade-Gery	– M&S.com operating profit – Plan A embedded in M&S.com	– Launch of new M&S.com website

As the threshold PBT level for the Scheme was not met, no bonus was payable for the individual objectives in 2013/14. However, the Committee has in place a robust process to assess the individual performance of each director. The table below illustrates the results of this assessment and the extent to which performance against the individual objectives was achieved. As the specific targets including those for PBT are considered to be commercially sensitive, they are not disclosed.

Profit			Individual				Total achievement (% of maximum bonus potential)
	PBT (60%)	Achievement against profit targets (60% of bonus)	Business area			Achievement against individual objectives (40% of bonus)	
			Cost targets (10%)	Plan A targets (10%)	Individual targets (20%)		
Marc Bolland	<div></div>	0%	<div></div>	<div></div>	<div></div>	19.5%	19.5%
Patrick Bousquet-Chavanne	<div></div>	0%	<div></div>	<div></div>	<div></div>	19.0%	19.0%
John Dixon	<div></div>	0%	<div></div>	<div></div>	<div></div>	19.0%	19.0%
Steve Rowe	<div></div>	0%	<div></div>	<div></div>	<div></div>	30.0%	30.0%
Alan Stewart	<div></div>	0%	<div></div>	<div></div>	<div></div>	19.0%	19.0%
Laura Wade-Gery	<div></div>	0%	<div></div>	<div></div>	<div></div>	24.0%	24.0%

Key

Below Threshold

Threshold – Target

Target – Maximum

Above Maximum

Key

Below Threshold

Threshold – Target

Target – Maximum

Above Maximum

Source: Marks & Spencer. Annual report and financial statements 2014, p. 64.

mined and how the company applied what was learned to its business. As stated in its 2014 report,

Starting in 2013, we once again used a multistep process to identify and prioritize the sustainability topics relevant for BASF. We started by collecting around 100 potentially relevant

subjects. A workshop and qualitative interviews with internal and external specialists revealed that 38 of these were particularly relevant. Using a global survey, we gathered feedback on these 38 topics from around 350 external stakeholders worldwide, as well as around 90 experts and managers from various functions within the company. The participants rated the topics in terms of

Figure 6 **DIMO Stakeholder Engagement**

The table below illustrates how we engage with our important stakeholder groups.

Stakeholder	Engagement Method	Frequency
Shareholders <ul style="list-style-type: none"> Owners Providers of capital 	<ul style="list-style-type: none"> One-to-one interviews (by independent parties) Annual General Meeting provides an opportunity to review the past year's performance and engage in discussions with the management Annual Report Quarterly reports providing a quarterly review of Performance Company Website CSE website 	<ul style="list-style-type: none"> Once every 3 years Once a year Once a year Once every quarter Online Online
Employees <ul style="list-style-type: none"> The key resource for competitive advantage and sustainable growth 	<ul style="list-style-type: none"> One-to-one interviews (by independent parties) Focus group discussions (by independent parties) Employee Council meetings Employee Portal of the company network accessible to every employee Annual strategic planning meeting Company's 'Open Door' policy encourages direct employee-management dialogue. Annual Employee Surveys – voluntary and confidential HR Clinics Individual Performance Reviews – bi-annually Employee Reward and Recognition 	<ul style="list-style-type: none"> Once every 3 years Once every 3 years Once a month Continuous Once a year Continuous Once a year Bi-annual basis across all business units. Continuous Continuous
Customers <ul style="list-style-type: none"> Principal source of sustenance 	<ul style="list-style-type: none"> One-to-one interview Customer Relationship Management process (CRM) enables the company to keep in touch with the customer on a daily basis. It helps to respond to queries and problems from the customer. 'Problem solving' for challenges the customer faces is also done through the CRM process. A Customer Satisfaction Index maintained by each business unit provides an assessment of satisfaction levels and helps to improve problem solving capacities within the Company. DIMO "Fleet Owners Clubs" for Loyalty Customers "Mercedes-Benz Club" 24 hour roadside assistance 	<ul style="list-style-type: none"> Once every 3 years 24 hours, 7 days Once a month/quarter Continuous Continuous 24 hours, 7 days
Business Partners & Suppliers <ul style="list-style-type: none"> Critical component of the Value chain 	<ul style="list-style-type: none"> One-to-one interview (by independent parties) A high speed 24 x 7 online link enables constant dialogue with principals. Issues discussed include product quality, marketing, customer satisfaction, 'problem solving' and employee motivation. On-site visits from principals and on-site visits to principals' location facilitate engagement. 	<ul style="list-style-type: none"> Once every 3 years Continuous Continuous
Society <ul style="list-style-type: none"> Local immediate communities Stakeholders in sustainable development Regulatory and government agencies 	<ul style="list-style-type: none"> One-to-one interviews (by independent parties) Focus groups discussion (by independent parties) Dialogue with Religious Dignitaries Written and oral communications initiated by stakeholders Company website One-to-One Interview 	<ul style="list-style-type: none"> Once every 3 years Once every 3 years Continuous Continuous On line Once every 3 years

Source: Diesel & Motor Engineering PLC Annual Report 2013/14, p. 35.

their current and future relevance for BASF. The results of this ranking are presented in a materiality matrix.

Finally, the findings were discussed in internal workshops and classified under eight overarching material aspects of sustain-

ability. The results of this materiality study and the eight aspects derived from it were presented to, and validated by, the Board of Executive Directors.⁴²

42. BASF, p. 29.

Figure 7 Sainsbury plc Risks and Uncertainties⁵⁰

A plan is in place to manage the leadership transition and the methods described above will continue to be employed to understand and maintain colleague engagement during this period.

↑ Data security

Risk

It is essential that the security of customer, colleague and Company confidential data is maintained. A major breach of information security could have a major negative financial and reputational impact on the business. The risk landscape is increasingly challenging with deliberate acts of cybercrime on the rise targeting all markets and heightening the risk exposure.

Mitigation

A Data Governance Committee is established and is supported by focused working groups looking at the management of colleague data, customer data, information security, commercial data and awareness and training. Various information security policies and standards are in place which focus on encryption, network security, access controls, system security, data protection and information handling. A review of key third parties who hold sensitive customer or colleague data continues to take place, and progress is monitored by the Information Security team. A risk-based security testing approach across Sainsbury's IT infrastructure and applications is in place to identify and remediate ongoing vulnerabilities.

↑ Financial and treasury risk

Risk

The main financial risks are the availability of short and long-term funding to meet business needs and fluctuations in interest, commodity and foreign currency rates. The business has now acquired full ownership of Sainsbury's Bank which presents a risk that the Group's financial performance and position may be negatively impacted if the Bank transition and performance is not delivered as planned.

Mitigation

The Group Treasury function is responsible for managing the Group's liquid resources, funding requirements, interest rate and currency exposures and the associated risks as set out in note 28 on page 114 to 119. The Group Treasury function has clear policies and operating procedures which are regularly reviewed and audited.

Sainsbury's Bank operates an enterprise wide risk management framework. The principal financial risks relating to the Bank and associated mitigations are set out in note 28 to the financial statements on page 119 to 120.

Source: J Sainsbury plc. Annual Report and Financial Statements 2014, pp. 24-27.

Like other manufacturers, BASF geared its learning toward product innovation.

In order to integrate sustainability further into our business activities, we launched a follow-up process in 2014 that translates the results of the materiality analysis into our steering and business processes. Categories of action were assigned to the individual aspects. A further step involved interviews with representatives from business, corporate and functional units, who assessed the business relevance of each category along the value chain. The results of this quantitative prioritization process show where along the value chain we have the possibility to take action with respect to each individual aspect. As a result, we have achieved a better understanding of the steps along the value chain where action needs to be prioritized in terms of the material aspects, and which topic areas we can influence with our actions. Building on this, we want to derive additional measures that maximize the positive effects of our actions and further minimize the negative ones.⁴³

They then divided their 60,000 specific product applications using their Sustainable Solution steering method into the following four categories: Accelerators, Performers, Transitioners, and Challenged. Of the 60,000 applications, 23% were flagged as "Accelerators" that contributed particularly to sustainability in the value chain. "Performers" meet the market's sustainability requirements, and 74.1% of BASF's

product portfolio was deemed to fit this category. "Transitioners" were products whose steps toward sustainability have been identified but they are not there yet—and the report explains the kind of innovation required.⁴⁴

Eskom, the South African public utility, and the Sri Lankan company, Diesel & Motor Engineering PLC (DIMO), both link their materiality matrices to stakeholder engagement and begin their discussions of materiality by focusing on that. As can be seen in Figure 6, DIMO's report lists its main stakeholder groups and the material issues associated with each. And consistent with our criteria for effective reporting, the issues were ranked by importance,⁴⁵ and the report includes a Risk Management Map that functions much like the materiality matrix that we look for.⁴⁶

When it comes to prioritizing risks, the report of Sainsbury's, the British supermarket retailer, stands out, along with those of Crown Estate and AkzoNobel. Sainsbury's significant issues are captured in a section titled "Our principal risks and uncertainties."⁴⁷ As can be seen in Figure 7, that section of the report describes five areas of business focus, and individual risks under each category are clearly defined and mitigation activities are explained.⁴⁸ In addition, the company identifies all material risks as having experienced as a result of the past year's efforts either "No change," "Increased gross risk exposure," and "Reduced gross risk exposure."⁴⁹

43. BASF, p. 30

44. While it is mentioned that their SAVIVA superabsorbents in pads and diapers reduce raw material consumption, specific numbers are not given. The fact that they made these designations was, however, indicative of integrated thinking. BASF, p. 36.

45. Diesel & Motor Engineering PLC. *Annual Report 2013/14*, p. 36.

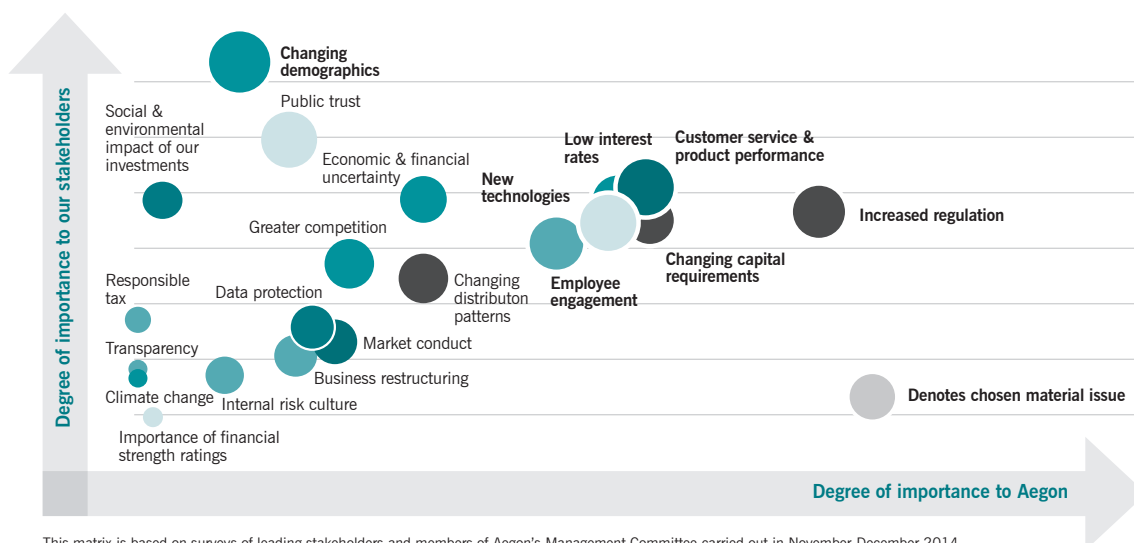
46. Diesel & Motor Engineering PLC, p. 97.

47. J Sainsbury plc. *Annual Report and Financial Statements 2014*, p. 24-27.

48. Ibid.

49. Ibid.

Figure 8 Aegon Materiality Matrix



This matrix is based on surveys of leading stakeholders and members of Aegon's Management Committee carried out in November-December 2014. Participants were asked to rate topics on a scale of 1 to 10 (10 being the most important). The size of each circle above relates to the number of participants selecting that topic as material. 'Ability to influence' is based on Aegon's own assessment (please refer to scale below).

Ability to control or influence

Direct control	Shared control	Strong influence	Some influence	No influence
Issue is entirely within the company's control.	Control of the issue is shared with, or exercised through, another company, organization or third party.	Company has ability to influence the issue within its own businesses and value chain.	Company has ability to influence, but only within its own businesses (not its wider value chain).	Company has little or no meaningful control or influence over the issue.

Source: Aegon. 2014 Review, p. 15.

The Crown Estate rated its risks in a similar way, noting changes in prioritization from previous years along with details for each risk/opportunity and its potential impact of financial (for example, on revenues) and nonfinancial (talent retention) performance, which are covered in a two-page table in the Governance report section that provides greater detail about the potential impacts of each issue.⁵¹

The materiality matrix⁵² presented in AkzoNobel's report identifies 18 risks or issues (from a list of over 200 topics) as being important to the company and key stakeholders. In an adjacent table, those risks were ranked from one to eighteen, with each identified as "high," "medium," or "low." For each of the risks, readers were told where to find more information about the risk. For example, the risk identified as "People and process safety" was discussed at some length in other sections called, "How we create value," "Strategic performance," and "Business performance," as well as in "Sustainability statements Notes 8 and 9."⁵³

In constructing and presenting its materiality matrix,

Aegon defines material issues as "those we believe have, or will have, a significant long-term impact on our profitability, our operations or our reputation."⁵⁴ The matrix (shown in Figure 8) identifies 20 risks and issues, of which seven are identified as "material." Within the matrix, Aegon places each of the 20 issues in one of five categories based on the company's degree of control over, or ability to influence, the issue: "Direct control"; "Shared control"; "Strong influence"; "Some influence"; and "No influence."⁵⁵ Aegon then explains the risks and opportunities within each trend and how the company is managing the risks, or even taking advantage of the opportunities presented by them.

Also, in what to the authors' knowledge is a first—although one that may well be copied by others in the future—Aegon's integrated report includes a "Management Board statement of significant audiences and materiality."⁵⁶ Among its other distinguishing features, the statement is signed by the Management Board and explicitly notes that the material issues are likely to shape the future of the company over the coming three to five years.

50. This image captures only a portion of the graphic published by Sainsbury plc.

51. The Crown Estate. *Annual Reports and Accounts 2014*, pp. 76-77.

52. AkzoNobel. p. 200.

53. AkzoNobel. p. 201.

54. Aegon. p. 15.

55. Ibid.

56. Ibid. p. 12.

Conclusions

The companies whose reports we mention in this article appear to have taken notice of the recommendations made by members of the Pilot Programme Investor Network⁵⁷ in their 2013 critique⁵⁸ of 19 integrated reports published by participants in the Pilot Program Business Network. The best of the reports we evaluated observed both the spirit and, though to a lesser extent in some cases, the letter of the <IR> Framework's Guiding Principles and Contents Elements.

When dealing with questions of strategic focus—which we view as one of the three main characteristics of an integrated report—the best reports provide clear explanations of the potential impacts of material financial, environmental, and social risks on corporate performance and value, and their efforts to manage such risks. The best of these reports also provide insights into how the companies expect to take advantage of opportunities in the broader market that are associated with, or created by, some of these risks. What's more, the most readily understood discussions of the business model tend to be those that use graphics and maps in varying degrees of detail to explain elements of strategy and considerations that might influence the business model over both near-term and longer-term horizons.

But if clarifying the link between corporate strategy and ESG risks is a hallmark of the best integrated reports, the holy grail is “Connectivity of information”—that is, the extent to which a report succeeds in quantifying the relationship between a company's environmental, social, and governance performance and its profitability and value. Concerns about information quality and internal controls limit the ability and efforts of most companies in furnishing quantitative information. Nevertheless, a number of companies used combinations of text and graphics to illustrate not only the relationships between financial and nonfinancial performance, but also management's understanding of these connections that must be made in order to build a sustainable strategy. The best reports tended to use simple techniques to improve navigation

within paper documents and, therefore, enhance the reader's understanding of the relationships between <IR> Framework Content Elements. These devices to link “Content Elements” include creating a connectivity matrix⁵⁹ to highlight all of the sections where a single topic appears, adding a sentence within a section to point the reader to related information, and including interactive icons that enabled the reader to access additional information on the corporate website.

Finally, discussions of materiality that are part of most reports have expanded beyond a simple matrix and now often include robust explanations of material risks and opportunities, especially in terms of known or potential effects on financial, environmental, social, or governance performance. One emerging practice we noted is the explicit prioritization of material risks and opportunities based on their magnitude/importance. A few companies included explanations of the role of their board of directors in the materiality process and, in some cases, their oversight responsibilities for the integrated report.

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57. The <IR> Investor Network is the successor to the IIRC Pilot Programme Investor Network. <http://integratedreporting.org/ir-networks/pilot-programme-investor-network/>, accessed June 2015.

58. International Integrated Reporting Council. Pilot Program Investor Network, “2013 Investor Critique Executive Summary,” <http://www.theiirc.org/wp-content/uploads/2013/10/IIRC-Pilot-Programme-Investor-Critique-2013.pdf>, accessed April 2015.

59. Strate. *Annual Integrated Report for the year ended 31 December 2014*, p. 6.

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