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CORPORATE Finance REVIEW

The CFO's Changing Role

The CFO as Corporate Prophet

The CFO, Shareholder Value Creation, and the Law

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TACKLING SHORT-TERMISM: MIGHTY TASKS AHEAD FOR INVESTORS, CORPORATIONS, AND FINANCIAL ANALYSTS

As the hoary expression goes, "Everyone talks about the weather, but no one does anything about it." As if we mere mortals could affect gigantic weather patterns! Similar things are often said about the prevalent short-term views of investors, corporate executives, and financial analysts. While we all can agree that a focus on the next quarter's performance vs. the long-term sustainability of the enterprise is not good for any of the market players, who is going to do anything about it?

The Conference Board (the Board),[1] the influential not-for-profit membership organization, has put what it terms *short-termism* in sharp focus and over recent months has begun to set forth remedies. These remedies encourage institutional investors, their professional advisors, financial analysts, and corporate boards and executives to think about "sustainability" issues as opposed to focusing on quarterly earnings forecasts or reporting, and to incorporate "extra-financial" (intangible) factors when interpreting analysis or deciding investment flows. Much work is ahead to make this happen, the Conference Board officials agree, but the work must start somewhere and sometime. And that time is now.

The Conference Board convened a "high-level" group of corporate and institutional investor representatives at a summit in London in July 2005 for deliberation on issues related to short-termism and in April 2006 published a report of the deliberations and the consensus reached by participants on key reforms and measures."Now, more than ever," the Conference Board concluded in its report, *Revisiting Stock Market Short-Termism,* "there are indications that corporations and investors can work together to actively address the issue of stock market 'short-termism' . . . ."[2] A "unique consensus" was achieved in London.

The London summit

The London summit[3] was sponsored by PricewaterhouseCoopers (PwC), hosted by Standard Life Investments, and held at the Association of British Insurers. The moderator was Dr. Carolyn Kay Brancato, director of the Conference Board's Global Corporate Governance Research Center (New York City). Participants included representatives of large pension funds (CalPERS, Hermes), large-cap corporations (Chevron, Coca-Cola Company), governmental bodies (such as Sweden's ministry of justice), trade associations (Council of Institutional Investors, Association of British Insurers), money management/investment banking organizations (Barclays Global Investors, Merrill Lynch), governance experts (the Corporate Library, State of Wisconsin Investment Board), and accounting/auditing interests (PwC, American Institute of Certified Public Accountants (AICPA)). A complete listing is available in the published report.

This gathering of disparate interests and points of view reached a consensus on the root causes of short-termism: It is a chain composed of three links, participants agreed: the corporate link, investor link, and financial analyst link. Delegates of the summit

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EXECUTIVE COMPENSATION HAS BECOME A PERPLEXING ISSUE AND INCREASING AREA OF RISK.

also agreed that it was time to address short-termism among all of these capital market forces and market linkages.

Developments shaping climate for reforms

Dr. Brancato observed, "We have been looking at the issue of how to get companies and investors to focus on long-term growth for more than 10 years at The Conference Board. Now, several important, new developments make change more possible ... than at anytime in the past." She cited these trends as part of a new climate in which reforms are possible:

- More leaders in the corporate and investor communities recognize and acknowledge the need to restore investor confidence in the international capital markets; market players recognize they need to restore credibility; the recent wave of corporate scandals in the US and EU has eroded both investor confidence and market credibility.
- Institutional investors are now taking dramatic steps to monitor more closely corporate management for the companies in their portfolios; "accountability" has become the watchword, with investment increasingly being directed with a long-term focus.
- Executive compensation has become a perplexing issue and increasing area of risk; investors are now focusing on the "pay-for-performance" issue, demanding that companies in their portfolios develop compensation schemes based on a better balance of financial and extra-financial performance metrics and indicators.
- Accounting principles are converging on at least one major area: development of models of corporate reporting based on true value drivers and inclusion of extra-financial performance measurements and intangibles. (Examples cited include data on customer satisfaction, registration of patents and encouragement of employees' professional development.)
- Recent empirical research projects support the linkage between sustainability—i.e., serious consideration of environmental, social, and corporate governance factors — and improved stock market performance (share prices) and enhancement of shareholder value. A "better company" is a "better investment" for the long-term, posits the author of *Revisiting Stock Market Short-Termism,* Dr. Matteo Tonello.
- Regulators, financial intermediaries, institutional investors and other third parties — "stakeholders," including a company's stockholders — are demanding more sell-side research focused on long-term corporate value. A recent major development: Key institutional investors participating in the "Enhanced Analytics" project agreed to allocate a portion of their brokerage commissions to long-term securities analysis that incorporates intangible or extra-financial measurements of performance and corporate measures of "success."

The debate on stock market short-termism is long running, dating back at least twenty-five years to the time when a large number of corporate takeovers — both friendly and hostile — began occurring, often for reasons of "financial engineering" rather than for strategic (and long-term growth) purposes. Takeover fever created massive change in the capital markets well into the 1990s. Short-termism became an entrenched phenomenon for corporations, investors, and analysts.

In the April 2006 report on the London summit, participants agreed that "change can only be accomplished through a concerted effort and inter-related efforts by capital market participants, undertaken simultaneously on many levels." The specifics of these efforts? Six major points given below.

Point one: perfect timing for focus on change

The time is ripe for a business and political climate to restore confidence in the capital markets, said key market players. During the dramatic, five-plus-years' run of recent corporate scandals — e.g., Enron, World-Com, Parmalat, Ahold, Vivendi, et al.—

other critical events and major factors were also affecting the capital markets and steadily eroding public confidence. These include the September 11, 2001 terror attacks in New York and Washington DC; war in the Middle East; investor exodus from collapsed stock markets in the US, Japan, Britain; a US recession; and rising anxiety about the availability and pricing of petroleum supplies.

The need to "correct the system and restore credibility became so imperative in the United States," the Conference Board noted, that initiatives came from all areas of society: Congress, the White House, federal prosecutors, state governments, the Securities and Exchange Commission (SEC) and other federal regulatory agencies, academics, associations of market participants, media, and especially institutional investors. The Sarbanes-Oxley package of legislative measures provided many of these players with powerful new tools to effect change in corporate and capital markets' behaviors.

In Europe, similar legislative changes take longer to be implemented (ratification is required by each member state). But significant efforts are underway to sanction individuals and disgorge their unlawful profits in the United Kingdom, France, the Netherlands, and Italy, summit participants point out. In the case of Italy's Parmalat, a government-appointed administrator moved quickly in both Italian and US courts to regain millions of euros from banks alleged to have assisted in the company's fraudulent behavior.

Given all this, London conference participants agreed, widespread "public sensitivity" to the issues surrounding well-functioning—and credible—capital markets is today "unprecedented in economic history." The global corporate community is being called on — in the US, European Union, Asia — to reexamine its traditional business strategies and to "appreciate the importance of the current public discussion on short-termism . . . ."

Point two: Shareholder activism matters—so does good governance

The Conference Board summit participants agreed that global institutional investors can be the major advocate of focusing on long-term growth — it is in their best interests, given their fiduciary responsibilities — and can and should encourage "sustainable" corporate performance. The clout of institutions is being felt today in many corporate boardrooms—where it matters most, according to Dr. Tonello. And it is not only the large institutions that are creating change; the aggregated resources and proxy voting power of many smaller institutions are also promoting positive enhancement of corporate governance policies and practices in public companies.

The world's large pension funds are making a difference. The Conference Board cited such global players as CalPERS and TIAA-CREF, the UK's Hermes, and the EU's Universities Superannuation Scheme (USS) as institutions having long-standing corporate governance reform programs that help to bring about significant changes in public companies. Some of these changes required publicly fought proxy contests and various types of legal challenges; some resulted from investor negotiations with corporate management and boards; and others resulted from increased (and generally unwelcome) scrutiny of companies and individuals by enterprising journalists who were encouraged by outside investors advocating for change. The apparent laggards: financial analysts, who have remained focused on short-termism.

The large public employee pension funds are, said the Conference Board, accepting that their mission should be to optimize the long term value of their fund(s) and that this mission should be the focus of a more informed and assertive approach to investment supply-chain management. What is new in the dialogue: It's no longer "good enough" for fund managers to act as if the long term is simply a collection of numerous "short terms" and that financial losses are hard (in retrospect) to evaluate on the basis of risk. ("Everyone missed the risk" is not a good excuse for analysts or advisors any more.) A constructive dialogue with corporate management could make it clear that the institution's focus is on the long term interest of shareholders, observed the Conference Board participants.

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PAY-FOR-PERFORMANCE COULD MOVE FROM A "HOT-BUTTON" TO "SCORCHING" ISSUE IN 2007 AND 2008.

Point three: The demand for pay-for-performance is real

London summit participants discussed pay-for-performance in depth and agreed that the related issues of short-termism and alignment of executive actions with long-term corporate strategic goals are at the core of the current heated debate—and shareholder focus—on the proper design of executive compensation schemes. At center stage now: correlating "actual executive performance" with executive remuneration. The current climate for debate is colored by rising indignation, the Conference Board observes, "[E]specially as investors learn that individuals directly responsible for catastrophic business results would continue to receive hefty paychecks or severance packages, as well as [continued] support of their boards . . . ."

What could help: creating better information flows between companies and investors, and companies and financial analysts, on exactly how executive compensation programs support "the achievement of a durable business strategy." Make no mistake, said the Conference Board, increased pressure on corporations to pay attention to the pay-for-performance issue is coming from investors, regulators, intermediaries, the courts, and media. Pay-for-performance is the hot-button issue in the US proxy season.

Citing data published by Institutional Shareholder Services (ISS), the Board noted that thirty-six pay-for-performance proposals were filed in 2005, which is five times the number filed the prior year. Some voting results approached majority status.

The SEC is also focused on the issue. It proposed rules for amending disclosure requirements for executive compensation and adopted new rules that will require a one-page, one-chart approach for all compensation of a company's top five corporate officers beginning in 2007. This will include cash compensation, long- and short-term incentives, stock options, restricted stock, value of pensions and postretirement packages, deferred stock, "gross ups," parachutes, perks such as private jet use, and "hidden" compensation. Pay-for-performance could move from a "hot-button" to "scorching" issue in 2007 and 2008.

Point four: "Extra-Financial" measures of performance are important

Conference participants agreed that it was important to the market that information about whether the company is making progress on its strategic direction be made more understandable—and well communicated by the company. The type of information communicated will, of course, vary from company to company, and by industry or sector. But, because business success today should translate into more than earnings growth and return on investment (ROI), said the Conference Board participants,"[I]t is important that performance assessment be based on a balanced combination of financial as well as extra-financial (or intangible) indicators." Absent this type of information, investors and financial analysts run the risk of seeing an "incomplete picture, and making unsound investment decisions (or analyst recommendations)."

The Conference Board's Global Corporate Governance Research Center's research dating from the mid-1990s on the topic of long-termism was reviewed and discussed at the London summit; the Conference Board asserts that its findings demonstrate the importance of companies' having enterprise-wide processes to select the range of financial and nonfinancial metrics for tracking success. The process could involve members of the board, senior executives, and line managers, and should look at short-, medium-, and long-term metrics.

Point five: Consider the impact of sustainability on long-term performance

While more popular in European business and investment circles, the issue of long-term "sustainability" has been growing in importance in the United States. (True, some US companies avoid the issue as a third rail of communication with stakeholders and shareholders.) The publicized results of recent empirical studies by international organizations and investment managers are focusing institutional investor attention on sustainability.

For example, a United Nations Environment Programme Finance Initiative (UNEP FI) study of eleven sectors involved major brokerage houses in Canada, Europe,

South Africa, Brazil, Japan, and the United States. Data results, said the Conference Board participants, show that long-term protection of shareholder value rests on "rigorous integration of such policies as climate change, internal governance, being open to shareholder proposals, innovation, scientific research, labor rights, and public health in corporate strategies . . . ."

In pharmaceuticals, for example, a Pfizer representative to the London summit commented that the industry is more open to long-termism given the potentially lengthy development process for new products, which may only materialize financially some ten or twenty years later. Pharmaceutical companies do invest for the long term and may be willing to increase transparency on sustainable projects that will be rewarded only in the long term.

Goldman Sachs contributed to the UNEP FI effort by developing social and environmental metrics for the energy sector; these were applied to information disclosed by issuers and resulted in a four-tier index. The Conference Board notes that BP and Shell stood out in the first tier while Russia's Yukos Oil and other emerging market energy companies were at the bottom (in part because of lack of disclosure or transparency). Goldman Sachs's paper stressed the importance of a long-term vision for executives and boards of oil companies.

Deutsche Bank developed a Corporate Governance Framework,[4] which was explained in a series of publications that it sponsored. The framework for the members of the "Global Equity Unity" at the bank includes the following:

- Analyzing key corporate governance issues across various country boundaries;
- Exploring the relationship between those various national standards and stock market risk (such as volatility);
- Quantifying the impact of key corporate governance standards on company profitability, evaluation, and its stock performance; and
- Integrating these standards and metrics into the portfolio management process.

Applying this framework to the S&P 500 and FTSE 1000 indexes, said the Conference Board participants, Deutsche Bank researchers found "corporate governance standards are an important component of equity risk" and that "companies decide what level of transparency and shareholder rights it provides . . . especially for companies looking to attract global investors . . . ." (Differences in legal and regulatory structures are a consideration.)

Point six: The securities research industry needs restructuring

It has been a long time since financial analysis was first well defined and the accepted common wisdom of analysis was set out by Benjamin Graham. Over recent decades, public companies have changed the way they do business and structure their finances; investors have broadened their range of investment vehicle choices; and equity and debt markets have become more global as well as much more complex than was the case six or seven decades ago. Has financial research kept up? Apparently not, in the view of summit delegates.

London summit delegates agreed that no matter what company boards and executives may choose to do to change the situation, the focus on the short term will be changed *only if and when* securities analysts get involved in the process—and commit to a change to long-termism in their analysis.

Quarterly earnings neither reflect corporate long-term viability nor provide a complete picture of corporate financial health. Earnings-per-share are not an accurate measure of long-term, sustainable performance or growth. Yet many financial analysts seem unable to move beyond these short-term measurements and beacons of financial performance, observed the Conference Board.

MANY FINANCIAL ANALYSTS SEEM UNABLE TO MOVE BEYOND THESE SHORT-TERM MEASUREMENTS AND BEACONS OF FINANCIAL PERFORMANCE.

The sell-side (brokerage) research industry is being challenged on all sides, and the traditional business model is in danger of disappearing. (That model is based on research costs covered by brokerage commissions or investment banking fees.) As pricing for share trading falls and appears to be heading for one cent per share (or less!), the pressure is on to develop a new business model. One has yet to emerge. The challenges are clear: When share trading was priced at eight cents per share, a broker-

DISCUSSIONS AT THE CONFERENCE BOARD'S LONDON SUMMIT WERE "PERMEATED" BY THE WIDESPREAD CONSENSUS ON THE NEED FOR CONCERTED CHANGE IN FINANCIAL RESEARCH.

age firm had three, four, or five cents' margin to pay for research. As trading revenues fall, research must find a new funding source. A number of large houses have already been slashing away at research staff in the US.

Electronic trading, order flow, major changes at exchanges, and other factors have rapidly been changing the business environment for financial research. SEC Chairman William Donaldson in May 2005 challenged the research industry to look beyond short-termism and said that the "quality of ... work is critical to determining the long-term cost of capital, and to measuring the vitality of our markets and our economy."[5]

The Conference Board participants noted that although securities firms have become more receptive to change, there remains a "cultural resistance" on the part of professionals that is the major obstacle to attempts to break down the vital intermediary link in the short-termism chain. Unfortunately, notes the Board, "despite increasing evidence for the materiality of environmental, social, and governance (ESG) factors to the fair value of securities, a study by UNEP FI and the World Business Council for Sustainable Development indicated that [these issues] are at best a peripheral concern for young financial analysts."

Hope rests with new analysts?

Where in the current chain of forces does the financial analyst sit? And what will it take to change CFA professionals' views on short-termism vs. long-termism? Interviews with younger analysts, said the Conference Board, are discouraging; discussions revealed that they are

- Typically uninformed on many ESG issues and long-term sustainability
- Unsure about how ESG or sustainable goals could be accomplished
- Skeptical about the impact of long-term sustainability on share price
- Reluctant to learn new methodologies and develop new analytical skills required to factor sustainability into their ongoing research
- Unconvinced of the marketplace demands or rewards for this type of research (experiencing little or no demand from client organizations)
- Doubtful that their own employers would reward them for recommendations based on ESG policies or corporate sustainability strategies

Discussions at the Conference Board's London summit were "permeated" by the widespread consensus on the need for concerted change in financial research. Perhaps, said the Board, young analysts may turn out to be the key agents of change inside financial institutions over the coming months.

Summit delegates' suggestions for action

The July 2005 London summit participants expressed an urgent need to address the problem of short-termism on both the macroeconomic and microeconomic levels.

- On the macro level, short-term vision is causing market volatility and the instability of global financial institutions.
- On the micro level, short-termism undermines management continuity, exposes companies to the risk of losing sight of their strategic business models, and compromises competitiveness. Embracing a short-term view could encourage corporations to externalize key costs, impacting communities and putting future generations at risk.

Solutions offered at the summit included future action on such issues as the following:

- Building on the summit discussions, further studies should be undertaken to explore the "deployment of intangible assets, to develop a set of sector-specific financial and extra-financial performance metrics."
- Disclosure frameworks now in development—being generated by both for-profit and not-for-profit organizations—could have unintended consequences (such as overregulation of the markets); a more reliable set of data on the market's appreciation "could facilitate the natural selection of one best practices model and encourage its widespread adoption."

- Continued research on intangible assets and extra-financial measures of performance should be based on voluntary trial programs, said the Board, with companies providing analysts and investors with more comprehensive information on value drivers.
- Adoption of the increasingly popular enterprise risk management (ERM) framework approach should be encouraged; summit participants saw ERM as an effective approach to assessing strategic and operational risk and as a means of communicating corporate long-term strategy to the market. (The Conference Board is involved in a continuing series of research projects on ERM.)
- As for pension funds, these institutions should develop internal governance practices "consistent with a long-termism investment outlook," including training investment managers (internal and external) in the selection of investments; also, these institutions could build incentives for fund managers to "become facilitators of a dialogue with corporate executives and directors to further long-term performance."
- Importantly, market players must enact a transition from antagonism to engagement; positive cases of corporate focus on long-termism and dialogue with investors could encourage others to follow the example.
- Legal research would help players understand the limits (say, for an investment manager with fiduciary responsibilities) of adopting the long-term strategic agenda—many players worry about their legal responsibilities and penalties for missteps. Common wisdom here is that asset managers must avoid long-term investment decision making where the financial outcome is "unassessable." The Conference Board points out that a recent global study by the United Nations — "A legal framework for the integration of environmental, social and governance issues into institutional investment" — revealed that most jurisdictions in the world do not support a single-minded pursuit of profit maximization by asset managers.
- Hedge fund management motivations should be investigated, said the Board, to ensure "their impact on certain market trends is fully understood."
- Finally, the analyst link in the short-termism "chain" must be "unlocked," said the Board; studies should be promoted to "identify a viable business model to profit from the sale of high-quality analysis of how to build a durable, long-term portfolio." The Board noted that a number of securities firms are now distancing themselves from short-term investment research; and with sustainability analysis becoming more important to a broader class of asset managers, an opportunity for analysts is emerging. The CFA Institute could develop a new cadre of analysts "focused on ... long-term corporate viability," as a concerted effort is now needed to establish a new community of leadership within the profession.

MARKET PLAYERS MUST ENACT A TRANSITION FROM ANTAGONISM TO ENGAGEMENT.

Improving financial reporting

On the issue of encouraging reporting "extra-financial" measures of corporate performance, summit participants suggested that these considerations might be important in defining the long-term sustainability of the corporate enterprise:

- An asset inventory where intangibles are classified according to their nature, location, and availability to the enterprise; and
- A quantifying of their intrinsic value, their "propensity to be strategically deployed," and their contribution to the growth of the business.

The participants stressed the importance of corporate managers' communicating information on their intangible assets to the markets. "Accountability" could rise or fall on such communication. Increased, comprehensive disclosure, said the Board, "would provide shareholders and stakeholders with the clarity needed to fully understand the real business value drivers and assess whether the corporate strategy is being properly implemented."

Accounting rules changes maybe needed: The Conference Board points out that under today's generally accepted accounting principles (GAAP), financial reports often suffer from "information asymmetries and other shortcomings." Investments on intangibles are expensed, not capitalized (such as for fixed assets) and as expenses increase, earnings-per-share decrease. Not an appetizing situation for today's senior managers who are being judged on short-term metrics and their meeting of shareholder expectations.

Corporate financial reporting—dynamic changes

But corporate financial reporting is changing; summit participants noted these dynamic changes underway:

- No market participant "fully believes" that traditional corporate annual reports now add value to the decision-making processes of investors. Market players gather information through many other sources (e.g., corporate-investor conference calls or discussions with investor relations officers).
- Such approaches as the use of economic value added (EVA), balanced scorecard, and cash flow return are real efforts by forward-thinking executives to provide more information to the markets.
- Self-regulating organizations (SROs), public sector regulators, accounting organizations, and rule-making bodies, among others, are making progress in improving disclosure principles and methods to encourage a "more complete and reliable representation of where the business stands and where it intends to go," noted the Board. Some advances are voluntary, and others are promulgated by government.

Looking ahead to future corporate/investor summits

The Conference Board will continue to conduct corporate/investor summits (coordinated by Dr. Brancato and the Global Corporate Governance Research Center) to explore many of the areas discussed at the London summit. While a strong consensus was reached in London on the need to change the stock market's short-term focus, the participants also agreed that making such changes could only come about through "a concerted and inter-related effort by market participants, undertaken simultaneously on many levels." •

NOTES

1 The Conference Board (www.conference-board.org) is a global not-for-profit membership organization headquartered in New York City that creates and disseminates knowledge about management and the marketplace to help businesses strengthen their performance and better serve society. The Board conducts original research, convenes conferences, makes market forecasts (such as the well-known "Consumer Confidence Index"), assesses trends, and publishes information and analysis. Members include leaders of business organizations in all global markets.

2 M. Tonello, *Revisiting Stock Market Short-Termism* (April 2006): Report Number: R-1 386-06-RR. A brief synopsis is available at http://www.conference-board.org/publications/describe.cfm?id=1 116 Dr. Matteo Tonello is senior research associate and acting associate director at the Conference Board's Global Corporate Governance Research Center. The content of this column is based largely on his reportage on the London summit.

3 The Conference Board series of Summits began in Fall 2003 with a convening of US and UK corporations and investors to discuss mutual concerns. The Conference Board approach is to develop "best practices" from research and discussion as opposed to recommending changes in law or regulation.

4 The Deutsche Bank's Corporate Governance Web page is available at http://www.deutsche-bank.de/ir/en/corporate_governance.shtml&loadFlash=/ir/en/1613.html.

5 SEC Chairman William Donaldson's speech to the CFA Institute (May 8, 2005) is available at http://www.sec.gov/news/speech/spch050805whd.htm