May
June
2012

CORPORATE Finance REVIEW

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CORPORATE FINANCE REVIEW (ISSN 1089-327X) is published bimonthly by Warren, Gorham & Lamont, Division of Thomson Reuters, 195 Broadway, New York, NY 10007. Subscriptions: $300.00 a year. For subscription information, call 1 (800) 950-1216; for customer service call 1 (800) 431-9025. Foreign callers (who cannot use our toll-free numbers) should call (914) 749-5000 or fax (914) 749-5300. We encourage readers to offer comments or suggestions to improve the usefulness of future issues. Contact Scott Gates, Editor, Thomson Reuters, 195 Broadway, New York, NY 10007; (212) 337-4129.

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CORPORATE BEAUTY CONTESTS: WHAT IS THE RANK/SCORE FOR YOUR COMPANY?

Many Americans seem to love corporate beauty contests—the constant ranking, rating, and scoring of perceived company corporate governance progress, or lack thereof, and related aspects of evaluating boards and managements of publicly owned, private-sector enterprises. Beauty contests, some may pejoratively characterize these exercises, or at the opposite end of opinion, increasing numbers of investors see these exercises as rigorous attempts to better define and in some way quantify really *effective* governance. And to differentiate the best examples from too many examples of *poor* governance.

What must the view be from inside the boardroom looking out? Some directors may be asking: *Who generates these 'best of/worst of' lists and rankings? What criteria are used, and to whom do these things matter?* The landscape may be seen as bewildering with the great range and variety of opinions being expressed (and widely circulated) by those outside the boardroom and C-Suite doing the judging of those inside the corporation.

As we have been detailing in the pages of this publication, over the last decade we have seen the emergence and continuing evolvement of evaluations of corporate performance with respect to three buckets of issues as represented in the framework of "ESG"—the environmental (E), including energy issues, social or societal issues (S), and corporate governance (G). These evaluations are of growing interest for mainstream asset owners and managers, including private equity, hedge funds, mutual funds, ETFs, and other investment pools. And of interest to non-market players who may be described as "corporate reputation influencers" as they assemble their rankings and ratings and lists of "best" and "worst" among publicly traded companies.

The concept of today's ESG frameworks and approaches evolved from somewhat different directions, and from the early 2000s onward, began to merge and evolve into a more comprehensive and definable framework for analysts and investors. After the spectacular financial misadventures of the Enron-era (featuring Enron, WorldCom, Global Crossing, Adelphia, Tyco, and later, Freddie Mac and Fannie Mae, and Lehman Brothers, and Bear Stearns), investors united in the quest for methods and methodologies to better evaluate and monitor corporate governance, as well as to define some of the outcomes of poor governance and oversight. (These issues are typically found in the laundry list of social and environmental concerns that are in focus today for investors.)

The phrase "what gets measured gets managed" is generally accepted in both corporate suites and investment offices. What is being measured in terms of ESG (and especially G for governance)? A wide range of issues and perceived areas of risk that boards and executives are expected to focus on, measure and evaluate, and manage (to mitigate risk).

Proxy resolutions as a barometer

One indication of the rising interest of investors and their campaign coalitions is the collection of shareholder-sponsored proxy resolutions presented for shareholder voting each year. As Kate Iannelli, a research associate with the National Association of Corporate Direc-

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tors (NACD), noted in July 2011 in *Directorship*,[1] the 2010 proxy season was marked by an uptick in the number of shareholder-sponsored resolutions focused on E and S issues—an increase of 27 percent over the past decade according to Ernst & Young.

Observed Ms. Iannelli: "The push for boards to consider other than board structure and executive compensation [perennial corporate governances issue for many investors] is supported with data from Proxy-Monitor.org, a tool developed by the Manhattan Institute for Policy Research to track shareholder proposals at Fortune 100(r) companies. In 2010, 37 percent of all submitted proposals focused on social policy, which included environmental, human rights and political spending." (That was higher according to the research than the 35 percent of proposals focused on traditional corporate governance or the 28 percent on executive compensation.) The percentage of social policy resolutions in the 2009 proxy season was 29 percent of the total.

THE 1996 REPORT CARD WAS THE FIRST *BEST & WORST* RANKING.

The corporate scandals—and search for metrics

In the October 7, 2002 issue of *Business Week* magazine (then owned by McGraw-Hill, now owned by Bloomberg LP), the cover story was a special report: "The Best & Worst Boards—How the corporate scandals are sparking a revolution in governance."[2] In the report (the fourth undertaken by the magazine), the *BW* editors noted that "a corporate governance revolution was underway, and as the list of companies engulfed in scandal, the momentum is building."

Stephen Shepard, then editor-in-chief, explained that back in 1996 ("before Enron was a dirty word"), the magazine had published its first report card on corporate governance, a topic which was "beginning to gain traction" with institutional investors and governance experts who were calling on boards to assume more active oversight, subject strategic plans to rigorous scrutiny, and assume responsibility for management succession. The 1996 report card was the first *Best & Worst* ranking, with results calibrated based on feedback from managers of the nation's largest pension funds, money management firms, and select corp. gov. experts.

That first class of "worst" group of companies in 1996 included such enterprises as Kmart, Warnaco, Archer Daniels Midland, Westinghouse, Walt Disney Company, and Time Warner—all of which experienced dramatic crises of one sort or another afterward, thanks (said editor Shepard) to weak board oversight.

Among the boards cited in 2002 for improved governance were Computer Associates (CA), Waste Management, and Cendant. "A big cleanup is underway," observed the editor. Not quite. In the years that followed the heads of CA would be convicted of fraudulent accounting (2006); Cendant would struggle and then implode (2006), becoming Avis and spinning off hotel and other business units to become much smaller; and Waste Management would in time become a positive example of the change underway.

The best boards in the view of those surveyed: 3M; Apria Healthcare; Colgate-Palmolive; General Electric; Home Depot; Intel; Johnson & Johnson; Medtronic; Pfizer; and Texas Instruments. Some of these companies would also experience corporate governance crisis moments in the years since 2002.

It's important to keep in mind that as the *BW* list was being compiled in summer 2002, the sweeping reforms embodied in Sarbanes-Oxley legislation were being signed into law by President G.W. Bush, and the Securities & Exchange Commission and other federal government agencies would soon begin their rule-making processes to implement the new laws (and upgrades of long-standing financial regulations dating back to the 1930s).

But did SOX serve to prevent similar scandals in the years ahead? Critics of the financial services industry would argue "definitely not!" after the spectacular collapse of that sector amidst a sea of collateralized mortgage debt assembled and marketed by the nation's top banking institutions. (See some of the best, most researched accounts by well-known authors in their recent "diaries" and tell-alls of the financial collapse of 2007–2009.[3])

Which ESG or CG metrics matter?

With the expansion of published or marketed corporate governance *ratings, rankings, list-making,* and *opinions,* we come to an importation question: Which corporate governance (or E, S, and G) metrics matter to analysts, asset owners, asset managers, and a wide range of external stakeholders? The answers are not easy to find. Some investment managers speak of having to scan many of the third-party offerings to come to a definitive answer that may be used in their investment evaluation and management duties as fiduciaries. The ratings and rankings business has become very competitive.

Recognizing the dilemma faced by both investors and corporate managers, the not-for-profit research organization Investor Responsibility Research Center Institute (IRRC), which describes itself as a "leading funder of research on corporate responsibility and investing," recently released a report, "Finding Common Ground on Metrics That Matter."[4]

In their research, authors Peter A. Soyka and Mark E. Bateman explained that investors increasingly focused on "sustainability" or ESG identify issues that typically revolve around environmental and social issues with real impacts and that are potentially very important over the long term. Among their findings:

- There is agreement on the importance of certain ("key") corporate sustainability issues—but not on the metrics or the purposes served by the metrics;
- These issues revolve around environmental and social factors that have real and potentially long-term or contingent impacts on corporate financial value;
- Traditional accounting metrics are less valuable in assessing sustainability issues than in the analysis of many other business issues;
- Investors and companies have a vested interest in receiving meaningful corporate ESG data;
- Companies may express concerns about the amount of time and resources needed to supply the quantity of data requested by third parties (the rankers, raters, and opinion-shapers);
- Investors typically view the ESG issues from a risk-mitigation perspective, not (yet) from a value-creation perspective; and
- Greater clarity and better communication is therefore needed for all uses of such data.

ESG issues in focus

What are the issues in focus in the three E, S, and G buckets? The researchers utilized the results of a national survey by the National Association for Environmental Management (NAEM)—"Green Metrics That Matter"—as well as data collected and compiled from publicly available information and interviews with ESG research teams.

The issues of importance include climate change, employee health and safety, use of renewable energy, environmental emissions, community involvement, water use and stress, waste and reduction of waste, e-waste, environmental management, diversity issues, and the nature of stakeholder engagement. Some investors consider these to be proxies for effective corporate governance as well as indicators of corporate sustainability over the long term.

Within these issue areas, the IRRC researchers found some common ground among (1) ESG analysts and researchers using the metrics and (2) company managements tracking the issues.

There are different endpoints for the use of the research, however. ESG researchers evaluate management quality and financial risk (and consider the materiality of the issues). Senior corporate managers are said to be informed about and are focused on (monitoring) sources of risk, but the authors found little evidence that companies are taking a strategic approach to defining their ESG metrics and using this data to inform their business strategies, identify new opportunities for revenue growth, or drive improved corporate-level financial results.

THE RATINGS AND RANKINGS BUSINESS HAS BECOME VERY COMPETITIVE.

SUGGESTED READING

For definitive reading on the investigative journalism published in the aftermath of the 2007–2009 meltdown see such works as:

- ***Bad Money*** **by Kevin Phillips (2008, Viking, New York, NY).**
- ***Money for Nothing*** **by John Gillespie and David Zweig (2010, FP/Simon & Schuster, New York, NY). This book details the failure of corporate boards to exercise proper oversight of their companies.**
- ***The Sellout*** **by Charles Gasparino (2009, HarperCollins, New York, NY).**
- ***Reckless Endangerment*** **by Gretchen Morgenson and Joshua Rosner (2011, Times Books/Henry Holt & Co.).**
- **For a first-hand account by a participant, see *On the Brink* by former Treasury Secretary Henry M. Paulson, Jr., (2010, Business Plus).**

The opinion-shapers and list-makers

Who are the ESG researchers that use ESG corporate performance data for their evaluation, ratings, rankings, opinions, and lists of "best and worst" companies? The IRRC authors included these in their own research efforts and in evaluating the quality of ESG data:

- Pax World and Calvert Funds (in-house Sustainable & Responsible Investment research by the leading SRI mutual fund advisors);
- Dow Jones Sustainability Indexes, as managed by SAM Group of Switzerland; FTSE4Good, managed by FTSE Group (and) KLD400, as managed by MSCI, the large index house; CRD Analytics, managers of the NASDAQ/OMX Global Sustainability Indexes (these are financial index managers incorporating ESG factors);
- MSCI IVA and Asset4 (the latter a service provider owned by the publisher of this journal, Thomson Reuters); both are research houses publishing independent ratings and providing asset management tools for ESG investing;
- Innovest Research, now part of the MSCI complex, and the Domini 400 Index, which is a guide for the Domini Social (mutual) fund (these were examined for historic comparisons by IRRC; both organizations have been conducting ESG research for many years); and
- *CR Magazine*; GoodGuide; Global 100; CSR Hub (key publishers of non-investor focused ratings).

For an idea of the range of ratings, rankings, and listings of companies using a variety of ESG factors by a very diverse universe of for-profit and not-for-profit organizations, it's worth examining the roster of third parties assembled by CSR Hub at www.csrhub.com. The web-based platform takes information from dozens of independent rankers and raters and generates in turn its own rating system (1 to 100) for public companies of all sizes.

The data sources for CSRHub are many and include "100 Low Carbon Pioneers," AccountAbility, Asset4, the "Burma Campaign" (anti-genocide), Ceres, the Chicago Climate Exchange, and 150-plus other sources. Among the well-known corporate governance raters and rankers included by CSRHub is GMI (the former Governance Metrics, Audit Integrity, and The Corporate Library, now combined as GMI).

ESG as important lens

ESG researchers are often using the issues and corporate strategies and actions taken as a lens for evaluating corporate managements. The corporate strategies and actions related to E and S issues are reflective of effective or substandard corporate governance.

Literally dozens of ESG analysts and investors are requesting comprehensive data and other information from managements in any given time period—many companies receive 20 or 30 requests for comprehensive data in a year. (Managements complain of "questionnaire fatigue." A Coca-Cola Company repre-

sentative at a recent governance conference said that the company received more than 300 such requests over the past year.)

What are the deliverables of ESG research? Deliverables are utilized for fundamental research by mutual fund management; with managers incorporating ESG factors in the selection of companies to be included in indexes (such as the Dow Jones Sustainability Indexes and the FTSE4Good as examples); asset managers factor research organizations' ratings and opinions for their asset management tools used internally and also provided to clients; some of the ESG research results are used for non-market orientated ESG ratings and rankings and list-making (some of the "beauty contests" referred to at the beginning). These may be widely circulated rankings, such as the annual "Newsweek Greenest Companies" list of the "greenest" (100) and (500) U.S. companies.

The IRRC report authors' conclusions:

- More clarity and transparency is needed on the relationship between (the company's) management of ESG issues and performance, and improved overall performance, and especially corporate financial performance;
- More information is needed about how closely disclosure reflects ESG management quality and performance; and
- It's clear that greater dialogue, information-sharing, and perspectives are needed.

And, therefore, many "reasonable" questions are appropriate to ask in the overall effort to help improve ESG evaluation (and to evaluate managements and presumably boards of directors). This is important as the ESG research field continues to mature and expand.

While the evaluating of boards and company managements by financial analysts, asset owners and their managers, and non-market participants (such as those organizations impacting corporate reputations) is important, there is yet no "standard" means of measuring and generating widely accepted metrics on corporate ESG performance.

There is *general* agreement about the key sustainability or ESG issues, which include many elements of effective corporate governance, but more than a decade after the Enron-era financial debacles there is still too much variance in the information gathered, processed, and published or made available by third parties that is focused on ESG factors and ESG corporate performance.

Third parties and corporate managements believe the same ESG issues are important, say the IRRC researchers, but track (and apply them) at different levels of detail and for different purposes.

Corporate sustainability strategies and efforts have been expanding over the past decade (since passage of SOX and, now, the Dodd–Frank package of legislation) and a growing number of investors and stakeholders are considering ESG factors as a barometer of effective corporate governance. Some aspects of the evaluations (and rankings and ratings) may appear to the casual observer to be a "beauty contest," but as the old expression goes, "beauty is only skin deep" when seriously considering the importance of some of the rankings and ratings of publicly traded companies in the U.S. The continued development of meaningful ESG metrics will help to underscore the importance of the ESG researchers' work. ■

NOTES

[1] Iannelli, K., Investors seek focus on non-financial issues, *Directorship / Boardroom Intelligence* (July 22, 2010).

[2] The best and worst boards: How the corporate scandals are sparking a revolution in governance, *Business Week* (October 7, 2002), McGraw-Hill, New York, NY.

[3] See sidebar on suggested reading.

[4] Soyka, P.A. and Bateman, M.E., Finding common ground on metrics that matter, IRRC Institute (February 29, 2012). Available at: www.irrcinstitute.org/projects.php?project=55. The National Association for Environmental Management (NAEM) participated in the research effort.