By MARK VAN CLIEAF

Board's due diligence

THE TIME HAS COME TO RAISE THE BAR ON EXECUTIVE ACCOUNTABILITY AND RESTORE INVESTOR CONFIDENCE

Capitalism in North America has mutated; corporate managers are growing wealthy at the expense of majority shareholders. Weak corporate governance, questionable accounting, excessive executive pay and greed have damaged investor confidence. Some even wonder if the capitalist system is broken. Scientists tell us any system that is allowed to self-regulate will either destroy itself or restore its own equilibrium. This basic law underlies Adam Smith's *The Wealth of Nations* and is the backbone of the capitalist system. Will modern corporations depend on government regulations or be able to self-regulate?

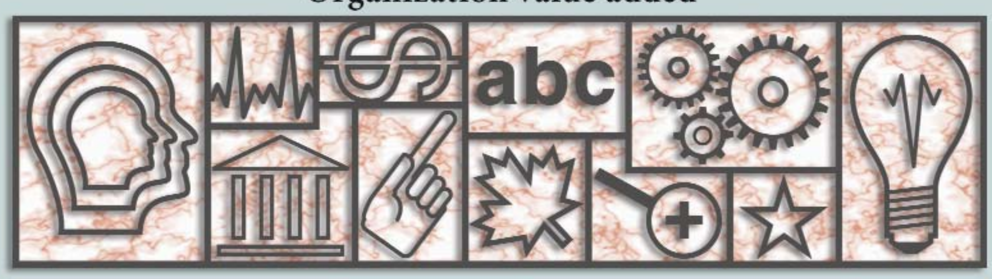
In other words, will boards, CEOs and CFOs restore the investor confidence required to drive a healthy capitalist system? There is a way to do this. However, just as changes in natural systems like earthquakes and hurricanes have unforgiving and unintended consequences, so do stock options, as a result the corrections in our corporations have to be dramatic and thought through at a systems level.

At the start of this year's annual meeting season, more than 200 proxy resolutions were directed at curbing CEO pay. But addressing pay levels only deals with half the issue of executive pay for performance. In many cases, CEOs are still held accountable for the wrong work and wrong metrics. Three questions need to be addressed: What should executives be held accountable for? What dimensions of performance should be measured and reported? Over what period should they be measured?

Boards are accountable for determining a CEO's accountability, how CEO and enterprise performance will be measured and how performance will be tied into compensation. If there was ever a time to clarify these issues, the time is now.

The foremost question for any board's compensation

Organization value added



Innovation	Planning	Leadership	Level of work complexity
Customer service	0 to 3 months	Lead self	1
Quality & continuous improvement	3 months to 1 year	Lead team	2
Process	1 to 2 years	Lead others who lead teams	3
New product / new service	2 to 5 years	Lead multiple functions / processes	4
New business model	5 to 10 years	Lead business unit	5
Stewardship / citizenship	10 years +	Lead multiple business units	6
Enterprise purpose / philosophy	10 to 20 years +	Lead global enterprise	7

Source: MVC Associates International

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committee is: how well is executive compensation connected to business performance? Using data provided by Stern Stewart, prior to the bubble bursting in 2000, we identified that over five years 32% of the S&P 500 failed to provide a positive operating profit after tax, after cost of capital (economic profit).

In Canada, similar data from the Corporate Renaissance Group, shows 65% of the TSE 300 companies did not return a positive economic profit over four years. The business model/strategy in these poorly performing firms is not working. There appears to be no link to executive compensation.

The board of directors needs to make clear its expectations regarding the creation of value. This includes the focus of the corporation's financial function and the link between value creation and business metrics. The traditional financial audit needs to be supplemented with an organization design audit, accountability structure and metrics to ensure the organization is designed appropriately to create value (a review of the Organization Value Added). This new audit can also assess the company 's leadership talent against key value creation measures. How many boards have taken this accountability very seriously?

Many companies are using an increase in stock price and related market value added (MVA) of the enterprise as key measures of success. Economists and analysts suggest 60% to 70% of the change in stock price is driven by global macroeconomic factors (interest rates, GDP growth, exchange rates), all beyond CEOs and their leadership teams' direct control.

Some 30% to 40% of the change in stock price is within management's control. But while stock price measures wealth creation, or destruction, for the shareholder, it does not directly measure the value creation capability of the business or its underlying economics.

Wall Street equity analysts have suggested that traditional measures such as earnings per share growth and return on equity are inadequate performance measures and are too easily engineered. EPS growth does not take into account risk in the industry/business; capital intensity/new capital required for growth; time value of money for capital invested; future net operating profit after tax (NOPAT) potential after the cost of capital; and the expense of stock options.

S&P in the United States has created a measure it calls "core earnings" to better capture its view of true value creation versus current GAAP. CSFB has found correlations between the increase in a firm's total value in the equity markets over two to five years (a measure of wealth creation for shareholders) and its business performance (actual financial results). There is a 50% correlation with increase in free cash flow and/or NOPAT minus cost of capital; 35% with return on equity; 18% with EPS growth.

To evaluate leadership effectiveness and enterprise performance properly, boards, CEOs, and CFOs need at least two separate financial measures: economic profit and shareholder economic return.

If investor confidence is to be restored, public companies should disclose their policies for performance measures and executive compensation

The economic profit concept began in the 1920s as "residual income." It is calculated as NOPAT minus the weighted average cost of capital (WACC). It has been used by such firms as McKinsey, Stern Stewart, Marakon and others under the banner of Value Based Management. Key underlying metrics include sales, sales growth rate and operating profit margin relative to the total invested capital of the enterprise. The spread between the return on invested capital and WACC shows the capital efficiency of the business model the leadership team has developed and the amount of true free cash flow the business will generate. This is the key to determining the market value of the enterprise in the equity markets.

Shareholder economic return includes the appreciation of the firm's stock price and dividends paid relative to investing in a risk free T-bill. The spread indicates an assessment of true cash earnings potential and the ability to realize the discounted current or future cash flow of the business strategy. The reflected increase in market value of the enterprise must be greater than the risk free T-bill to create risk-adjusted shareholder wealth. Shareholder economic return also reflects how well senior management has communicated expectations for the future, the business strategy and financial forecast to analysts, key institutional investors and the business media. A positive shareholder economic return indicates incremental shareholder value has been created.

Analysis of S&P 500 proxy statements identified that 55% of these firms are only measuring leadership performance and business results over single-year periods.

The granting of stock options was supposed to align the interest of management and directors with shareholders. Companies have confused three- to five-year vesting of stock options with three- to five-year measurement of true business operating performance, mistakenly assuming the vesting period would focus management on the longer term. Standard stock options failed to create the line of sight to operating performance that produces sustainable shareholder value. Executive compensation consultants who advised boards and management didn't understand the unintended consequences of the use of options. Surprisingly, many have said they are experts in compensation, not measurement and pay for performance.

If investor confidence is to be restored, public companies should disclose their policies for performance measures and executive compensation, including:

- A three- to five-year measure of the change in NOPAT minus the cost of capital. NOPAT divided by the total amount of capital tied up in the business will provide a fully loaded return on capital measure. To create value, this rate of return must exceed the cost of capital.
- A three- to five-year measure of relative total shareholder return (ideally adjusted for risk compared with investing in a T-bill). This should be indexed to a comparative group of companies so senior management doesn't get a free ride because the total stock market went up.
- To create a more balanced, socially responsible and customer-centric scorecard, measures related to customers, employees,

the organization and the society in which the business operates should also be included. Of the S&P 500, 95% have no measures here.

We often encounter senior executives and CEOs who are not clear on what their unique contribution should be. We have found they commonly:

• Spend too much time on operational details, micro-managing their direct reports and meeting short-term targets.
• Do not spend sufficient time on transforming their business model and strategy to sustain and develop the enterprise.
• Are not held accountable for this strategic work by their chairman or board and are overpaid for their current work.

Accountability in organizations in a knowledge-based economy should move decision authority from a centralized vertical command and control structure to distributed decision-making at the right level. Compensation should no longer be based on the size of the business, budget or team, but on the complexity and added value of the work. Decision-making authority should no longer be based on title or status, but on the capability to plan and manage resource investments at various levels of work and innovation.

Through our research and experience we have developed an organizational audit and design framework based on the unique accountability and contribution at each level of real work. Seven levels of work are defined, based on complexity jumps of scope, variety, uncertainty and decision-making in relation to such factors as innovation, planning horizon, leadership and resource management. Each level contributes to sustainable value creation (see chart on page 46). Designing in these requisite work levels and related accountability and decision authority helps to ensure the enterprise's sustainability and its ability to anticipate change and create value for customers, shareholders and societies in both the short and long term. This framework indicates how many organizational levels are required for sustainable growth and value creation and what the unique contribution of each level is.

We have used this framework to conduct accountability audits in such sectors as financial services, packaged goods, retail, pharmaceutical, advertising and government. We have found two key organizational barriers to designing executive work and accountability that add value.

First, the financial planning, reporting and measurement systems tend to be one-year focused. Also, the financial metrics may not include a capital efficiency measure linked to return on invested capital or economic profit. Second, job evaluation methodologies are outdated. They tend to be based on the size of the business, budget and team managed with no link to value-added contribution, such as impact on multiyear growth in revenue, cash flow and return on invested capital. Few competency models and approaches to succession planning define the executive skills required to create value. Human resource methodologies designed for middle management in an industrial economy don't work for executive work design and talent management in a knowledge economy.

In reinventing corporate governance, executive accountability and pay for performance, the board and the CEO should ensure that the level of work and related accountabilities of the CEO are matched to the business strategy. They should also ensure that the accountability and decision authority structure is appropriately cascaded into the organization, and that performance measurement and the requisite leadership capabilities are aligned at each work level. Compensation for both internal value creation and external wealth creation should be tied into this organizational structure.

The board, CEO, CFO and senior human resources executive need to ensure alignment of organizational systems (work design and accountability, performance measurement, pay for performance, and talent management) to create the leadership selection and development plans that will drive sustainable growth in economic profit and capital-efficient business results in the long term. This organizational capability is the underlying driver of growth in shareholder value and the board needs to ensure this capability is in place. Such self-regulation is only a matter of time.

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