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COMPENSATION

The New DNA of Corporate Governance: Strategic Pay for Future Value

by Mark Van Clieaf and Janet Langford Kelly

Despite all of the controversy over excessive executive compensation, with differing views expressed by institutional investors, board members, judiciary, and media, the real issue about executive pay-for-performance has not been addressed. Most long-term incentives do not hold senior executives accountable for creating the long-term intrinsic value of the enterprise. Thus, most Chief Executive Officers (CEOs) and other Named Executive Officers (NEOs) lack any true accountability and direct line-of-sight regarding the expected value of future growth and innovation beyond the current performance of existing operations.

Recent studies indicate that, for the median of the Russell 3000, approximately 59 percent of enterprise value is based on expectations of future growth, innovation, and expected value compared to profits and cash flow from current operations.[1] These expectations represent $7 trillion in US market value as of May 2003.[2] In order to realize the promise inherent in today's enterprise value and stock price, a company must have a value-added organizational architecture that drives senior executives to focus on the creation of

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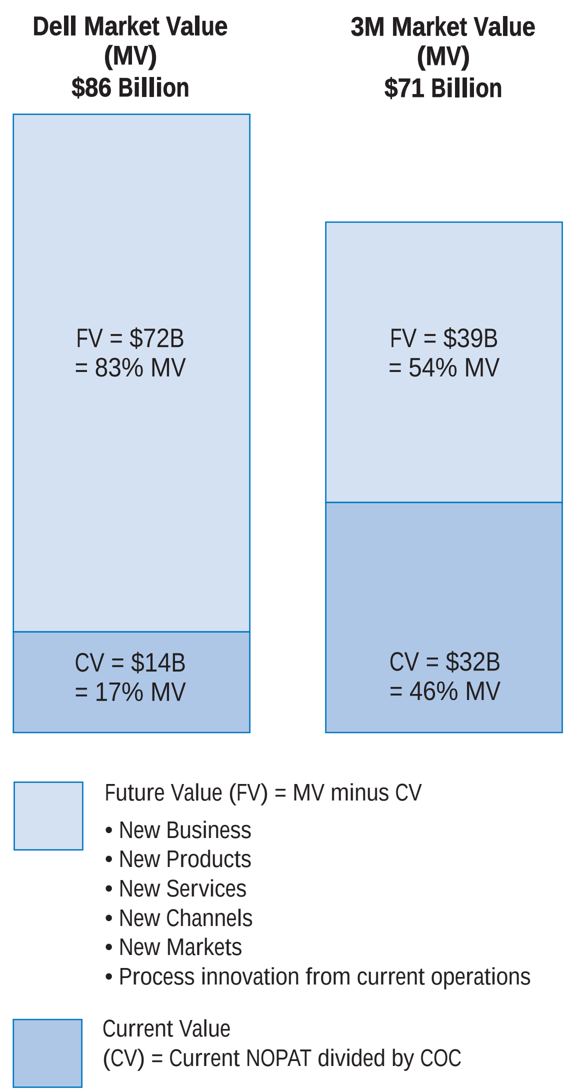
future value from sources other than current operations. This includes three-year or longer strategic metrics to evaluate management performance.

A review of 2004 proxy statements by Paul Hodgson of The Corporate Library concludes that 85 percent of companies have failed to set the multi-year performance targets that would encourage management to pursue the creation of that longer-term value. Rather, typical targets today include annual improvements in earnings, cash flow, and sales from current operations.[3] So what has not been fundamentally addressed in the executive compensation debate is that a majority of North American listed companies are only holding their CEO's accountable for operational work; not for building longer-term sustained growth in intrinsic value and shareholder wealth. Yet far too many CEOs are being compensated as if they were performing this strategic work and longer-term value creation for shareholders.

Figure 1



Perhaps not surprisingly, given this lack of correlation between short-term targets and longer-term intrinsic value and shareholder wealth, our financial analysis indicates that 56 percent of the top 2,100 US listed companies failed to increase their intrinsic value (net operating profit after tax minus cost of capital) over the five-year period ending in 2003. Of growing concern to investors is that a total of $250 billion in executive compensation was paid in the past 10 years to the top five officers at listed companies, but many of these companies had and still have above-median executive pay for below-median enterprise performance.[4] If North American companies are to create the future growth, innovation, and returns on invested capital necessary to enable pension funds and other institutional shareholders to meet their long-term fiduciary obligations, this alarming disjunction must be fixed.

Allen Sykes, the author of *Capitalism for Tomorrow*, summarized this issue neatly in a recent conversation with us:

> Every relationship in shareholder capitalism is distorted when boards and management only focus on short-term goals . . . If the accountability structure of what the board holds the CEO accountable for is wrong, then every relationship and process in the organization is dangerously skewed and the organization will not be run in the long-term interest of its shareholders and broader society.[5]

This article is the first in a three-part series about the New DNA of corporate governance, where we offer a new paradigm for executive accountability, organization design, and pay-for-performance that will enable boards to create alignment between what is expected of executives by the capital markets and for what CEOs and NEOs should be held accountable. In the second part, we will outline specific process failures in today's approaches to pay-for-performance and describe new processes, tools, and an ideal compensation model that boards can apply in aligning organization design and strategic pay with the drivers of enterprise value. In the third part, we will address the emotional issues often raised by directors. These include directors being too concerned about being perceived as confrontational by the CEO rather than providing the constructive criticism that CEOs need when the board sets challenging goals for them and about reducing the risks of losing a CEO/NEO by more clearly defining executive accountability and linking pay-for-performance to longer-term goals.

An Enterprise's Intrinsic Value

At any given time, a company's enterprise value and stock price take into account the value of the company's current operations and performance as if it continued in perpetuity. We refer to this as a company's current value (CV). There is also a portion attributable to value expected to be created from future growth and innovation. We call this a company's future value (FV).[6] The portion of enterprise value attributable to current operations can be calculated by dividing a company's current net operating profit after tax (NOPAT) by its cost of capital (COC). The expected future growth value (FV) can be calculated by subtracting the value of current operations (CV) from the company's market capitalization or enterprise value (MV).[7]

The expected future value to be created can be further broken down into:

- The future value from current operations (i.e., future process innovation of current operations that drives organizational and capital efficiencies); and

- Future value from new growth and innovation (which includes new products/ new services/ new market or business model innovation, all of which can be accomplished in part through mergers or acquisitions).

For example, Figure 1 illustrates the breakout between the CV and FV at 3M Company and Dell Computer Corporation.

The FV of companies typically varies by industry sector, with industry averages from as low as 16 percent in banking and 23 percent in food, beverage, and tobacco to highs of 106 percent for media and 127 percent for technology equipment and hardware companies.[8] The FV of some companies is actually negative, which means that the expectation of future value created by a company and its leadership team is actually negative relative to the current operations cash flow, and the equity markets have already discounted the stock price to less than the intrinsic value of the current operations of the enterprise. We call this negative Leadership Value Added—LVA™.[9]

This raises a red flag about two questions: Are the named executive officers being held accountable for one- to two-year operational versus three-year plus strategic work? How effective and credible has senior management been in communicating its strategic plan to shareholders, given that it is not recognized in the enterprise valuation? The Figure 2 illustrates further with example companies based on 2003/2004 enterprise valuations.

Intrinsic Value versus Stock Price Appreciation

Because the expectation of earnings, free cash flow, and return on invested capital greater than the cost of capital to be created from future growth is embedded in enterprise value, there can be a mismatch at any

Figure 2

Company	Future Value (FV) as % of enterprise value (MV)	Future Value (FV) as $ value of enterprise value (MV)
E-Bay	92%	$42 Billion
Microsoft	72%	$163 Billion
Pfizer	50%	$143 Billion
Proctor & Gamble	49%	$74 Billion
Monsanto	32%	$3.8 Billion
Harrah's Entertainment	28%	$2.9 Billion
Kellogg	17%	$3.8 Billion
Whirlpool	Negative 17%	Negative $1.4 billion
Fannie Mae	Negative 23%	Negative $16 billion
RBC/Royal Bank	Negative 31%	Negative $12 billion
Louisiana-Pacific Corp	Negative 52%	Negative $1.7 billion

(Source: MVC Associates International)

given time between the company's stock price and its underlying business fundamentals and intrinsic value (the present value of expected future cash flows over the remaining life of the business). When the two are in alignment, the stock price accurately reflects the increase in intrinsic value (known as Value Builders) or its destruction (known as Value Destroyers).

When they are not in alignment, the stock price can overestimate the future value creation potential (known as Value Myths) or underestimate it (known as Hidden Value). Our analysis of the top 2,100 US public companies identified that, over the five years ending in 2003, 29 percent were Value Myths.[10] These companies had an increase in stock price and enterprise market value but a decrease in intrinsic value and free cash flow (Net Operating Profit After Tax minus Cost of Capital) during the same five-year period. At some point in the future, the enterprise value and stock price of these companies should fall to reflect the underlying fundamentals and intrinsic value. This is what happened in the recent dot.com bust, when executives cashed out short-term options and long-term shareholders were left with the remaining intrinsic value.

Changes in intrinsic value appear to be strongly affected by the decisions of the senior executive team. Although it might seem that intrinsic value would be largely dependent on the industry sector in which a company operates, our research shows that almost every industry sector includes companies that have created both intrinsic value and shareholder wealth over the past 10 years.[11] The only factor that we have been able to identify to account for value creation differences within the same industry sector over time is the difference in the business model designed and implemented by management and how they chose to invest capital.

The Mismatch between Market Expectations, Executive Accountability, and Compensation

Despite the obvious importance of focusing senior executives on strategic work that will create new products, services, and business models—the expected value of which is already embedded in a company's stock price—currently the accountability of senior executives (and their compensation) relies heavily on metrics that can be easily manipulated in the short term and do not necessarily reflect the creation or destruction of longer-term intrinsic value of the enterprise (*e.g.*, economic profit and market value added).

Options, restricted stock, and other equity incentives directly, and the measures used for most so-called long-term incentive plans (LTIPs) indirectly, create executive reward based on shorter-term (one - three year) EPS targets, increases in stock price and total shareholder return (TSR). Over the short term, the problem with using stock price as a proxy for value creation is the future growth expectation inherent in the stock price. At any given time, the senior executives of a company can be creating more than the future value expected by the market, less than the future value expected by the market, or the same amount of value. Thus, compensation that rewards executives based on short-term stock prices or total shareholder value rewards them for the value the market expects them to create—*whether they are doing so or not.*

Not only are such short-term targets potentially inconsistent with the actual value being created by executives at any given time, the pursuit of short-term targets can actually interfere with longer-term innovation and value creation. The reward that an executive with stock options

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can reap from an increasing stock price in the short term, combined with a lack of a holding period for the stock obtained through exercise, has encouraged senior managers to act in risky ways that are inconsistent with the long-term interests of the enterprise and its long-term shareholders.[12] Option holders, for example, have more incentive than long-term holders to seek a highly leveraged capital structure or to roll the dice with shareholder capital on risky projects with potentially high rewards, including acquisitions (50 percent or more of which arguably have failed to create shareholder value).[13]

Even worse, some executives appear to be prepared to compromise the long-term health of the enterprise to meet such short-term targets. A 2004 survey of more than 400 financial executives found that:

> 80% of respondents report that they would be prepared to decrease discretionary spending on R&D, marketing, advertising, training, and maintenance to drive future innovation and sustain the enterprise in order to meet short-term earnings and EPS targets. More disconcertingly, more than half the respondents state that they would not be willing to burn 'real' cash flows by, say, delaying new projects and capital expenditures for the sake of reporting expected financial market numbers. Their survey further reveals that the most important reason why managers care so much about earnings announcements is the effect on stock price.[14]

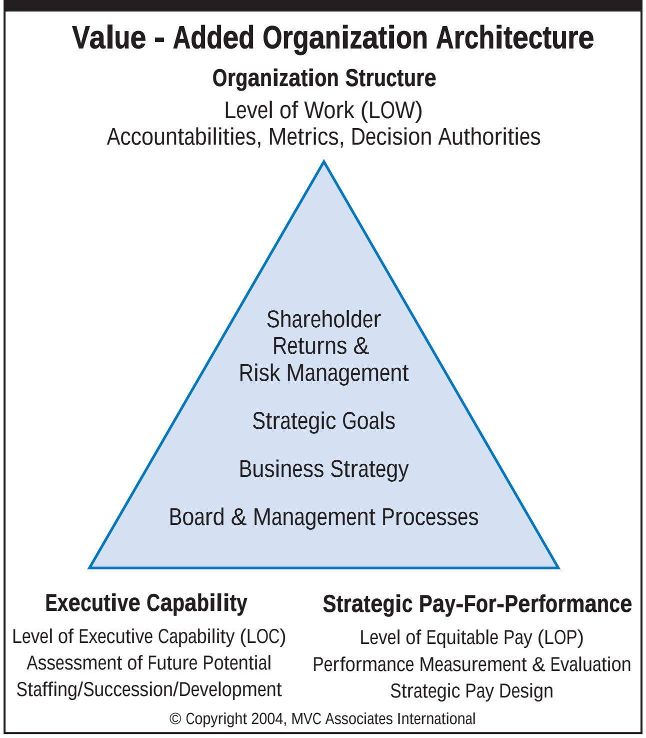
Even aside from such incentives, when pay design focuses senior executives' attention on shorter-term operational goals, such as EPS and TSR, no one is doing the true job of the senior executive—the hard strategic work of ensuring that the company has the business model, products, and competitive capabilities to enable it to sustain itself over a three- to 10-year horizon and beyond. Yet, an array of important market participants, such as pension funds (like Hermes, TIAA-CREF, CalPERS, CalSTRS, Ontario Teachers Pension Plan), credit rating agencies, consultancies (for example, McKinsey, Marakon, Stern Stewart, and Accenture), and judges, all appear to assume that boards are setting strategic three-year plus goals for management, including a good faith attempt to create profit, free cash flow, and return on invested capital greater than the company's cost of capital.

It appears that far too many boards have no grounding in effective accountability design and defensible executive compensation principles and practices. In the absence of an objective framework for understanding and designing an effective organization structure and executive accountability, many CEOs have defined their own role, accountabilities, and level of authority. Even those few directors with some knowledge of accountability design often fail to use their knowledge. More than one director has told us that they have not established clear three- to five-year accountabilities and performance metrics for their executive team for fear of seeming confrontational. Designing an effective accountability structure and integrating it with executive compensation are the most powerful levers that a board has to protect itself and reward the financial interests of its shareholders.

The Board's Role in Driving Intrinsic Value

So, what should boards be doing to make sure that the companies that they govern have the right business model, organization design, and senior executive compensation plans to create future value? What should boards be doing to discharge their "strategic duty" to shareholders?[15] We suggest that a board ensure that the company has the following components of organization design and leadership architecture (see Figure 3) that aligns structure with leadership capability and incentive/rewards systems to drive business strategy and shareholder value, including:

Figure 3



1. A three- to five-year or longer strategic and organizational plan that directors and management both believe in, with clear and measurable goals and accountabilities for management (what, by when, with what resources, and where) and decision authorities for achieving the plan (not just an aspirational plan with no clear accountabilities);

2. A leadership team capable of performing at the level of complexity required by that plan (now and in three to five years from now) and dedicated to doing so; and

3. The use of a performance evaluation, measurement processes, and a pay-for-performance compensation design that focus senior executives on the creation of long-term value pursuant to the strategic plan and that enable the board to assess the execution of the strategic plan over time, while equitably sharing the value created between employees and shareholders (*i.e*., labor and capital).

Level of Work and Expected Enterprise Value

First, the board needs to step back and assess how much of the company's current stock price and enterprise value is based on future value to be created from new products, services, and business models. In comparing that to its knowledge of the company and its industry, the board can determine the complexity of the task ahead, which will inform all its other choices, including those regarding leadership, organizational structure, and pay design.

In making this determination, boards could benefit from a framework called "Levels of Work" (LOW) and "Levels of Executive Capability" (LOC) that has been developed by MVC Associates based on more than 10 years of research and application (much of this was previously outlined in the November-December 2004 issue of the *Corporate Governance Advisor)*.[16] Briefly, this framework identifies five levels of CEO work and five levels of corporate governance. These levels are based on principles of complexity and how they relate to value creation, not the size of the company. At any given time, a company's strategic needs will be at one of these five levels.

The LOW framework uses six factors to determine which of the five levels of work and innovation is required by an organization at any given time to sustain itself as a viable economic system. Four of these factors are (1) the level of innovation complexity; (2) planning horizon; (3) level of complexity of assets/capital managed; and (4) level of complexity of stakeholder groups to be managed given the number of different businesses and countries in which the enterprise may operate.[17]

There are five corresponding levels of CEO capability. The Level of Executive Capability (LOC) identifies the level-specific conceptual, planning, and other competencies that match to each requisite Level of Work. Each jump in level is a discontinuous jump, both in terms of work complexity and conceptual, strategic, and economic thinking, and each level of work deserves to be compensated differently.[8]

In a recent McKinsey survey of 1,000 directors, 55 percent said that they wanted to know more about the health of the organization for which they were a director.[19] The LOW and LOC framework is like the DNA double helix, and we see these 5 Levels of Governance and 5 Levels of CEO Work (LOW) and the matching LOC as the building blocks of the "New DNA" of corporate governance. These building blocks provide meaningful substance, processes, and diagnostic tools for the board, management, and investors to assess the organizations health and future value creation potential.

In other words, not all CEO roles are created equal. To illustrate the different levels of work for which a CEO role might be accountable, consider the CEO positions at Eli Lilly and Johnson & Johnson, both great companies. Both are CEO positions in the same industry, but the level of complexity of each CEO role, and therefore the ability of each CEO role to innovate and add customer and shareholder value, are quite different. To name just a few differences, Eli Lilly has essentially one global full profit and loss center, operates in approximately 20 countries, and does not have a robust acquisition effort; whereas Johnson & Johnson has three sectors of businesses in some 200 decentralized full profit and loss centers operating in approximately 57 countries and has $400 million in an internal venture capital company to seed new business models. The leadership skills required for success in a role as complex as the Johnson & Johnson CEO role are distinctly different from those required for the Eli Lilly CEO role. In fact, the relative level of equitable compensation (Level of Equitable Pay-LOP) for these two CEO roles should be at least a 4x differential based upon empirical evidence.[20] Traditional peer group comparisons for executive compensation often result in overpayment for less complex CEO roles and underpayment for more complex CEO roles.

The use of a meaningful process to define the CEO role, its accountabilities, and matching executive capabilities is one of the more fundamental duties for directors. The *Disney* decision is just the latest court decision to find that boards must have meaningful processes that will result in informed judgment, including by seeking the advice of independent outside experts when appropriate. Yet in the recent survey of directors conducted by McKinsey & Company, 53 percent said that they really had no meaningful process and agreed upon goals for evaluating the CEO.[21] Boards that do not understand the differences between companies and the complexity of their CEO roles, accountabilities, and the future expected value will almost certainly make mistakes in those decisions most central to the discharge of their duties and their opportunity to create long-term enterprise value: hiring the CEO, evaluating CEO performance, approving pay-for-performance, and planning for CEO succession.[22]

A board might have difficulty establishing that it was informed when it made executive selection and executive compensation decisions if it lacked meaningful process and did not even consider the basic, fundamental issues related to clearly defining the accountability and capability of the CEO role (there are five possible levels) for which it has oversight. Without being informed, including through the appropriate use of external expertise to advise the board, directors might even be found to have acted without good faith and face personal liability.[23] The five levels of CEO work and matching levels of executive accountability provide a research based framework and meaningful process that enables boards to fulfill their duty.

Once the board has identified the right LOW, its next task is to determine the matching LOC. By defining the CEO's LOW, the board has also defined the correct number of levels of management required in the entire company and the Organization Value Added-OVA™ that can be added by the manager at each LOW below the CEO.

Through an accountability audit of the CEO role or the top three to five organizational layers (which is like an MRI for effective organization design), boards and management can assess the true alignment between organization structure, compensation systems, leadership capability, business strategy, and shareholder value as an outcome. The starting point is an organizational diagnostic that clarifies the level of complexity and value-add of key executive positions, like the CEO role, by examining a number of job design factors including:

1. The level of innovation for which the role is held accountable; including consideration of:
    - Process innovation and productivity improvement
    - New product/services innovation
    - New business model innovation
2. The customers/stakeholders for whom the role needs to work with in order to add the highest value, including consideration of:
    - Existing customers related to today's products/services
    - New and existing customers for new products, services and markets
    - Key stakeholders that impact the external environment on a country level in which the business operates and could impact creating a new business model
3. The length of time into the future for which the role is held accountable for planning and results, such as:
    - One to two years
    - Two to five years
    - Five to 10 years

Each of the six LOW factors is used to assess a role's current LOW and accountability, identify overlapping roles in the accountability structure, and redesign accountabilities to remove significant role overlap and compensation that is providing little to no return.

All too often an accountability audit identifies:

- Executive roles that are held accountable at too low a LOW, leading to a company that is too short-term focused and not designed to create longer-term sustained value for shareholders (an organizational gap);[24]

- High levels of compensation commensurate with a much higher LOW complexity paid to executive roles primarily accountable for operational work;

- Titles failing to reflect the true level of value added accountability and decision authority (title creep); and

- Companies holding two or three levels of management accountable for producing the same results with the same accountabilities and metrics, resulting in poor organization design and a wasteful use of compensation (an organizational jam-up).

The Importance of Defining the Level of Work and Platforms for Growth

After the board has determined the highest LOW facing the enterprise (and thus the LOW and LOC required of its CEO role) and is satisfied that it has a senior executive team with the right LOC, the board and the executive team can work together to create a multi-year business and strategic plan for growth. This plan should identify both the required growth in revenue and economic profit and the expected sources of that growth (*i.e.*, how much will come from which of the following growth and value platforms):

- Current operations and customer loyalty

- Process innovation and improvements to current operations

- New products/services/market innovations

- New business model innovations

A key foundation for growth and value creation is the relative health of the existing core business and its sustainability. Unless the growth and value creation potential of the core business is managed correctly, the company should not, and probably will not have the cash flow to, effectively innovate at a level that creates longer-term value. If the core business is in poor health, pressure from both debt and capital markets will make it difficult to get out of the trap of a short-term survival and a quarterly earnings focus. Managing current operations effectively, including return on invested capital, is the first organizational building block.

Once a company has growing cash flow and increasing returns from the core business, it has earned the right to grow through higher levels of innovation. To better understand where the expected growth and value drivers are, a board should map out the enterprise LOW and the forecasted three- to five-year change in economic profit by each LOW. It should also compare how well the growth and value matrix correlates with how equity analysts view the company and its future potential with the future value built into the current enterprise value. A company that is firing on all cylinders for growth and innovation in a balanced manner should find itself with growth platforms that drive sustainable value and, in the longer term, create intrinsic value, and shareholder wealth. The board should then assess whether the organization design, role accountabilities, and three- to five-year incentive systems truly drive the strategic plan and growth platforms.

The figure below outlines the growth and value matrix that emerged from a recent board discussion about strategy and the link to the LOW. In this company, the following three- to five-year strategic/business plan forecasts were mapped out by LOW.

- Three-year growth targets in economic profit from the current operations of $450 million (including incremental value of $50 million to be achieved through process innovations in the current business operations);

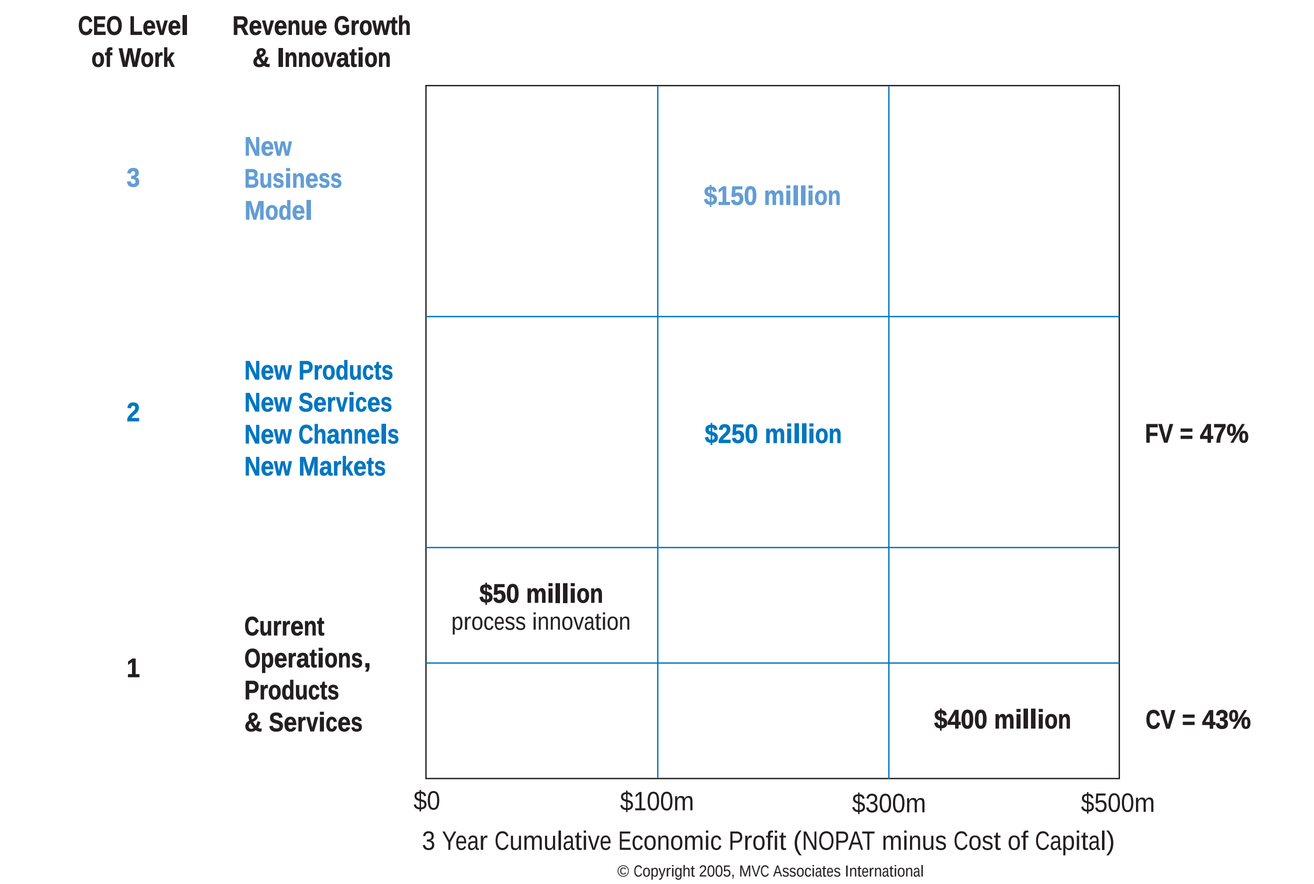
- Three-year growth in economic profit from new product, new service, and new market innovation of $250 million; and

- Three-year growth in economic profit from a new business model that will generate $150 million in new value and return.

The plan should also identify which roles are accountable for which specific parts of the business plan. For example, a pharmaceutical company might assign accountability this way: innovations and economic profit from the performance of current operations and patented drugs (current products and services) to director-level employees; accountability for new drugs currently in clinical trial (new products and services) to vice president and senior vice president levels; and accountability for proteomics and genomics for drug discovery (new business model) to the CEO, the highest LOW for this enterprise.

Figure 4

5 Year Business/Strategic Plan & 3 Year Targets



The Board's Duty to Design Strategic Pay for Future Value

Once the plan has been fleshed out in this manner, the growth and value matrix by LOW can be used to develop a strategic pay-for-performance plan. The questions to be answered in establishing a compensation plan tied to LOW include how labor and capital should share in the value created and to which achievements against the strategic plan and specific goals should each executive's incentive pay be linked.

To answer the first question, the board and management should look carefully at the plan and the intrinsic and shareholder value to be created from it. So, for example, at the beginning of a rolling three-year business planning cycle, the board and management would agree on the three- to five-year metrics and specific three-year targets for growth and value creation that emerge from the plan. Once these targets are set, a strategic pay-for-performance plan can be devised that outlines, in advance, the total amount to be allocated to total executive compensation under various scenarios of both three-year absolute economic profit and a three-year increase in the indexed Market Value Added for the company.[25] Figure 5 indicates the various levels of total direct compensation that might be triggered and awarded to the NEOs three years into the future based on the achievement of various levels of both cumulative absolute intrinsic value creation and increase in indexed Market Value Added.

For example, if the NEOs meet the performance targets of a three-year cumulative $800 million in economic profit, they would share in an incentive pool of $81 million to $180 million depending on the indexed Market Value Added. If they miss the three-year milestones for intrinsic value, ROIC, and Market Value

Figure 5					
Sample: Strategic Pay for Performance Payout Scenarios - CEO Level 3 Enterprise					
3 year Cumulative Economic Profit in millions	**3 year Total Cost of Management** Targeted Cumulative Total Direct Compensation for Top 5 Named Executive Officers in $ millions				
$1,000m	101	105	110	120	200
$900m	91	95	100	110	190
$800m	81	85	90	100	180
$700m	71	75	80	90	170
$600m	61	65	70	80	160
$500m	51	55	60	70	150
$400m	41	45	50	60	140
	3 year indexed Δ Market Value Added (Δ enterprise value minus debt, equity + earnings indexed to the Russell 3000)				
	$50 million	**$250** million	**$500** million	**$1** billion	**$5** billion

Added and achieve only $600 million in cumulative three-year economic profit, then the total amount available for longer term incentive compensation will be from $ 61 million to $160 million depending on the incremental change in the indexed Market Value Added.

If they meet stretch performance targets ($1 billion in economic profit and $5 billion in indexed MVA), the NEOs will share in a total three-year strategic pay-for-performance compensation pool of $200 million, which works out to 10 percent of three-year cumulative economic profit, including incremental value created from new products, new markets, and a new business model, and 2 percent of the incremental three-year shareholder wealth created above the Russell 3000 index.

In all the above strategic scenarios, executive compensation is only triggered and then awarded if three-year performance conditions are achieved, after which we recommend a further three-year vesting period, resulting in a total six-year end-to-end pay-for-performance cycle.[26] The role of the board in exercising its discretion in approving final compensation payouts relative to the goals and targets set will be addressed in part two and three of this series.

To answer the second question, the board must determine for each executive role the specific three-year or longer goals and targets to which incentives will be tied and the structure of the arrangements. At the CEO/NEO level, incentive arrangements must be very specific regarding growth, profit contribution, ROIC, and other targets from growth and innovations in new products, new markets, and new businesses, which is the unique contribution and decision authority of the executive team and their real Organization Value Added-OVA™. The board should also ensure that the key performance indicators selected demonstrate that positive momentum is being created so that enterprise growth and sustainability will carry the company forward far beyond the specific three-year targets set in the strategic pay-for-performance plan.

To test the alignment between pay and business performance for long-term incentive plans, the board can also look at its projected payout/performance ratio on a comparative basis with performance measures, such as economic profit, ROE, ROIC, and free cash flow, using the following dashboard:

Top 25% Pay/Top 25%
percentile performance = Green light

Top 25% Pay/50-75%
percentile performance = Yellow light

Top 25% Pay/25-50%
percentile performance = Flashing Orange light

Top 25% Pay/Bottom 25%
percentile performance = Bright Flashing Red light

Three year metrics for economic profit or EVA™, ROIC, free cash flow, or cash flow return on investment are suggested because these are more value-based metrics. They:

- Are better measures of true value creation than GAAP accounting measures, which are accrual accounting measures and not measures of cash generation; and

- More accurately reflect the true level of risk and total capital invested in the business; and make meeting the numbers more difficult to engineer because they use three-year (or longer) performance periods.

Many of the leading pension funds and credit rating agencies expect these measures to be used, for the above reasons.

A longer-term pay-for-performance plan (LTIP) designed to align with the requisite organizational structure should truly enable a company to leverage its organizational design, leadership talent, and compensation dollars to create sustainable future value.

Notes

1. Accenture Outlook 2004, Matrix Investment Research, MVC Associates International.

2. Ballow, Thomas and Roos, "The $7 Trillion Challenge," *Accenture Outlook 2004*.

3. Stern, Stewart & Co., "How Companies Worldwide Pay their Executives," p.10.

4. Lucian Bebchuk and Yaniv Grinstein, "Growth of US Executive Pay," Harvard Law School working paper, Jan. 2005.

5. Allen Sykes, Capitalism For Tomorrow—Reuniting Ownership and Control (Capstone Publishing 2000).

6. The portion of enterprise value not attributable to the value of current operations may include components of excess speculation and broad macroeconomic drivers as well as the expectation of future value to be created, but the important point is that this component of enterprise value represents the portion of enterprise value that is not the perpetuity value of current operations.

7. Cost of capital is calculated as the weighted average cost of capital, including a cost for debt capital and imputed cost/return on equity capital.

8. Analysis by Accenture, Matrix Investment Research, and MVC Associates International.

9. Leadership Value Added-LVA™ and Organization Value Added-OVA™ are trademarks of MVC Management Corp; EVA™ is a trademark of Stern Stewart & Co.

10. See Mark Van Clieaf "New Liabilities for Compensation Committees," *The Corporate Board*, Jan. 2005.

11. This research is also confirmed by research of the Corporate Renaissance Group and Marakon Associates.

12. Donald P. Delves, "Stock Options and the New Rules of Corporate Accountability," (McGraw-Hill 2004); see this quote from p.3: "Born out of the intent to make executives think and act like shareholders, option grants created something entirely different: enormous incentives for executives to think and act like option-holders, with far shorter-term and riskier perspectives than is healthy for most companies."

13. "Deals that Create Value," *McKinsey Quarterly*, 2001 No. 1.

14. Working paper of John Graham, Campbell Harvey, and Shivaram Rajgopal summarized in "Pay for Short-Term Performance: Executive Compensation in Speculative Markets," Patrick Bolton, Jose Scheinkman, and Wei Xiong, Princeton University, Oct. 13, 2004.

15. The idea of a board's "strategic duty" as part of its fiduciary duties to shareholders was suggested to one of the authors at an ICGN conference in Oct. 2004 by a member of the Delaware judiciary.

16. This includes more than 400 interviews at the Global CEO, Group President, and President levels to identify how the role design and competencies change at each level of complexity of general management that creates shareholder value. We have also further elaborated in March 2005 issue of *Directorship*, "The DNA of Corporate Governance" and the May 2004 *Ivey Business Journal*, "Are Boards and CEO's Accountable for the Right Level of Work?"

17. Through a half-day facilitated discussion with a board, MVC Associates has assisted boards in identifying the Level of Work required by an enterprise to sustain itself and live up to the performance expectations built into enterprise value and stock price.

18. These leadership accountability levels and leadership domains have been further validated over the past 40 years through thousands of management interviews based on LOW organization design principles, Stratified System Theory and the design of decision and control processes known as the Viable Systems Model. The original research contributors upon which our research was built includes Elliott Jacques, Gillian Stamp, David Billis, Warren Kinston, Walt Mahler, Stafford Beer, Luc Hoebeke, and others.

19. *McKinsey Quarterly*, 2005 special edition: Value and Performance.

20. For a more thorough analysis of the differences of the two CEO roles, and how the compensation would need to be calibrated to take those differences into account when comparing compensation (which does not occur with the typical adjustment for size of revenues and market capitalization of a company, assuming there is any compensation calibration), *see www.compensationstandards.com* or *www.mvcinternational.com*.

21. *McKinsey Quarterly*, 2005 special edition: Value and Performance.

22. *See* Sydney Finkelstein, Why Smart Executives Fail (Penguin Group, 2003). Although the book does not look through the lens of LOW/LOC, many of its examples illustrate the consequences of having a CEO whose Level of Capability is below the Level of Work required by the enterprise.

23. The recent WorldCom and Enron settlements, in which directors agreed to personally pay nearly $30 million back to shareholders, have confirmed for many that the risk of personal liability for directors is quite real.

24. This problem of executive accountabilities at too low a level, leading to excessive compensation, is reflected in a recent NYSE Compensation Committee Chair's response to the SEC Chair about the NYSE's CEO compensation. In this response, accomplishments of the NYSE over 2000 and 2001 are outlined as the performance metrics linked to their longer term incentive plan and executive compensation payout. Yet the majority of the accomplishments listed were operational and productivity improvements over a period of two years; work that Vice Presidents or even lower level managers should be accountable for, and for much less, compensation.

25. "Market Value Added" is defined as enterprise value minus all invested capital (debt and equity plus retained earnings); indexed Market Value Added is indexed against the Russel 3000. A special thank you to Ken Stewart, FSA, FCIA, MAAA, of Stewart Advisory Inc. in Toronto for assistance in developing the strategic pay-for-performance payout table and methodology.

26. For further examples of true LTIP design, *see* the 2005 General Electric and Johnson & Johnson proxy statements.