CORPORATE
GOVERNANCE
REVIEW

Volume 16 No. 3 April / May 2004

Are Boards and CEOs Accountable For the Right Level of Work?

By Mark Van Clieaf

This is a review by the author studying the disconnect between executive accountability, compensation and company performance. The author describes a defensible approach to defining a CEO's Level of Work and accountability and looks at the implications of these Levels on enterprise performance and for Director Nomination and Compensation. The complete article was originally published in the Ivey Business Journal and is available at www.mvcinterternational.com

Vincent Sarni, former Chairman & CEO of PPG Industries said it best: "A CEO of a public company must recognize the difference between corporate assets that belong to the shareholders and their own, personal assets…. The day a CEO crosses this line and mixes the two up is the day they are in trouble."

There is more than enough evidence for this breakdown in corporate trust:

- Of the 500 companies making up the S&P 500 in 1957, only seventy-four remained on the list through 1997. Only twelve outperformed the S&P 500 index in Total Shareholder Return over the same time period (McKinsey & Co.). Based on this track record, the longer-term sustainability of many corporations is in question.

- Ninety-five percent of the S&P 500 companies have failed to disclose any criteria for non-financial measurement of corporate and social responsibility (MVC).

- Over a five-year period, 45 to 50 percent of the largest public companies in North America (1800 companies) have failed to provide an after-tax return on invested capital greater than their cost of capital. Their business strategies/ models are therefore not viable. Moreover, the boards and CEOs of these poorly performing companies are apparently not using the right metrics to assess enterprise/CEO performance, or the link between performance and executive compensation (MVC).

In This Issue

P.1 Guest writer, Mark Van Clieaf, argues that many CEOs and their executive teams are not being held accountable by their Boards for the right Level of Work. With executive accountabilities improperly defined executive compensation is not so as much 'excessive' as it is 'inappropriate'.

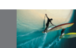
P.9 British Columbia's corporate legislation undergoes an overhaul.

P.10 Disappointment in the face of innocuous voting results disclosure.

P.10 Governance News – BC's security legislation next in line; OSC Re-filings and Errors List; TSX announces new ticker designations for dual-class capital companies; Alberta and Ontario race to limit the liability of income trust unitholders; CSA tables amended continuous disclosure obligations for mutual funds.

P.11 Company News Briefs - Poison pills; Looming proxy fight at Dimethaid.

A bi-monthly publication of
Fairvest
AN ISS COMPANY
Suite 1400, 67 Yonge St., Toronto, ON, M5E 1J8
Phone 416 364 9000, Website: www.fairvest.com
a subsidiary of Institutional Shareholder Services



- Over a ten-year period, sixty-one percent of mergers and acquisitions failed to create shareholder value (McKinsey & Co.).

- A review of compensation policies in proxy statements indicates eighty-nine percent of the S&P 500 CEOs and their executive teams are not held accountable, or paid, for business (as opposed to stock market) performance beyond 2 years (MVC).

These statistics raise an important question: are boards, CEOs, and their executive teams held accountable and paid for the right kind of work? With the increasing level of shareholder activism, and new court precedents related to corporate governance an executive compensation, how prepared are CEOs and Directors to answer the following questions at the Annual General meeting:

- What are the 3 to 5 year key performance metrics and targets that the CEO and executive team are being held accountable for and how did the Board determine these metrics?

- What is the Board's process for evaluating management and how do you tie compensation into these metrics to make pay-for-performance a reality for shareholders?

- Is there any discrepancy between what is disclosed in the proxy statement and how executive compensation decisions are actually made?

Our research indicates that fifty percent of the CEOs in North American public companies have roles and accountabilities with limited to no impact on the creation of long-term shareholder value. And if CEOs and their executive teams are held accountable for and measured on operational work while being paid for strategic work, they are overpaid. In this article, I will further define the problem and suggest a way for making CEOs and Boards accountable for the right work—work that actually creates long-term shareholder value.

The Core Problem

The core problem lies in how different levels of accountability are designed, measured, and audited—or not, in many cases. Popular enterprise performance measures have proven grossly inadequate, and even the accountants can't agree on how to measure profits. Equity capital was never free, even though most companies failed to account for the cost of stock options and an imputed cost of equity capital in determining earnings and executive compensation.

To compound the issue, boards and compensation consultants use role titles, size of company, reporting lines, organization and capital structure as benchmark comparisons for executive compensation. These factors tell you almost nothing about the true complexity of executive work, current accountability, and what those executive roles should be accountable for to create longer-term value.

Surprisingly, many executive compensation consultants I interviewed stated, "We are experts in compensation, not measurement." Given that accountants and compensation consultants who support the board compensation committee both have deficient measurement models, it is fair to say that executive pay for performance is broken at the core.

Accountability and Measurement: Clear, Meaningful Definitions

If a board is to turn this crisis into a golden opportunity for renewal, it must address two related decisions:

- **How the board defines the accountability and performance measures of the CEO.** Most boards have failed to define CEO accountability clearly and assign it at the right level of work.

- **How the board measures the success of the enterprise.** A short-term focus on quarterly earnings per share and stock price jeopardizes a long-term sustainable shareholder return.

That is the top layer of the problem. When we dig a little deeper we find evidence of the following:

- Not all CEO roles are created equal, but many institutional investors, boards, compensation and executive search consultants treat them as though they are.

- Too many CEO roles are defined at an operational level, which is too low a level of work and leadership accountability to create customer or shareholder value ten, seven, or even three years into the future. Performance measures, and rewards that focus on annual financial performance, compound this issue.

- Because the CEO work is not properly defined, many CEOs are overpaid.

A board has ultimate the authority for defining a CEO's level of accountability (as this article will show, there are five levels). In doing so it must decide:

- CEO effectiveness and performance evaluation
- CEO compensation
- CEO succession.

The failure to clearly define and assign CEO accountability at the appropriate level is one of the main reasons why the short-term mentality – and the crisis in business leadership – exists today.

All CEO and Board Roles Are Not Created Equal

Not all CEO roles have the same level of work complexity and accountability, and many role and compensation comparisons are indefensible. For example, the work of the CEO role at Johnson and Johnson is exponentially more complex than it is at Eli Lilly. Similarly at Procter and Gamble versus Kimberly Clark. Yet a number of the companies and CEO roles Eli Lilly and Kimberly Clark boards chose for compensation benchmarking are far more complex than those roles of their own CEOs.

Given its higher level of work complexity and accountability, the CEO compensation band at Johnson and Johnson and Procter and Gamble should be two to four times higher than that for Eli Lilly and Kimberly Clark.

Most boards and compensation consultants lack a clear framework for comparing CEO and other executive roles and compensation across companies. Many boards have no grounding in effective accountability design. In the absence of an objective framework for designing accountability and measuring work, many CEOs have defined their own role, accountabilities, and level of authority. Thus current compensation practices continue unabated. Designing an effective accountability structure and integrating it with executive compensation are the most powerful levers a board has to protect the financial interests of its shareholders.

A board cannot defend its decisions about executive selection, compensation, or succession planning to shareholders without a standard measure for defining and comparing executive work, leadership accountability, and the required level of executive capability. This is a core problem with board governance. It raises the question of what a single framework for board and CEO accountability design and measurement should look like and contain—what principles, processes and tools could a board use to turn this crisis into an opportunity?

Level of Work: A Framework For Board and CEO Accountability

CEOs, boards, and institutional investors would benefit from a framework called Level of Work [1] to help design executive accountability, assess executive leadership capability, and establish equitable and defensible levels of executive compensation. Applying Level of Work organization design principles ensures each level in an organization has differentiated accountability, authority, and processes, and adds unique value for customers and shareholders. The framework uses six factors, four of which are innovation complexity; planning horizon; complexity of assets/capital managed; and the complexity of stakeholder groups to be managed (for example, if the enterprise operates a number of different businesses in various countries).

Ten years of research and over 400 interviews at the Global CEO, Group President, President, and Vice President/General Manager levels have provided insight into five levels of work complexity and CEO leadership accountability. The five levels of CEO work cross three major domains of leadership work: the Operational domain, the Business Development domain, and the Global Industry domain (see Figure 1).

Figure 1: Level of Board / CEO Accountability
(What is the unique contribution?)

Leadership Domain	Level of Work & Innovation	Range of Required Capability
Global Industry • Current / Future Societies • 10-20 yr + Balance Sheet Strategy, optimizing TSR and Cash-Value-Added for Societies • Transform Industry Structure / Cultures • Create change globally • Leadership of business Leaders • Identity & Policy Control	**Level 5) Global Business / Societal Innovator** Creates enterprise sustainability, new industries (R&D), and wealth creation for global society, by managing the inter-dependencies between economic, environmental, social and political factors worldwide	Evolve a business philosophy and ideology, managing the inter-dependencies between capitalism, globalization, sustainable development, and democracy (existing & emerging) for current and future generations
	Level 4) Industry Innovator Model corporate citizenship / stewardship, policy and investment strategies leveraging business models across multiple geo-political, socioeconomic,& technological boundaries	Define enterprise purpose, business conduct & principles that transcend business models and cultures; define/enforce governance, value systems & societal standards; Redefine the rules across multiple economic systems
Business Development • Current/Future Stakeholders • 2 to 10 yr Investment Plans • New Products, New Businesses & Return on Invested Capital • Anticipate change nationally and globally • In-Direct Leadership • Strategy & Management Control	**Level 3) New Business Model Innovator** Transform the business model leveraging customer, competitor, regulatory, capital market, NGO's and other socio-economic factors	Transform previously accepted rule systems about the business model to create new business rule principles to sustain competitive advantage for the business system
	Level 2) New Product / Service Innovator Integrate and synthesize stakeholder needs resulting in development of NEW products, services, markets & channels	Combine principles from multiple business functions / complex processes to guide action on inter-related sub-systems, recognizing non-linear and non-obvious rule relationships and unintended consequences
Operational • Current Customers • 1-2 year profit plan / EPS • Operational & executional efficiency • Respond to change locally and nationally • Direct Leadership • Operational Control	**Level 1) Process Innovator** Optimize process, technology and people to deliver a suite of products & services to meet the needs of current customers	Combine a number of elements in creating multiple options, based on a systemic pattern of rules, to design core business processes

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Size of business, budget, reporting lines, and number of employees do not determine the level of complexity of CEO/general management work. The following, from a research report by Dr. David Billis of the London School of Economics, and based on his twelve years of work on developing and implementing a global Level of Work approach in Unilever, furthers the findings:

"How could a national company with a turnover of $1 billion manage with the same number of management levels as a comparatively small company with, say, a $200 million turnover? How could their Managing Directors both be in the same level of work? At first sight the analysis, which led to this conclusion, was greeted with disbelief by the larger company. So the interviewing and analysis was done again and again. The result remained the same. Complexity and the value added at each level, not sheer size was the driving force of this new approach in defining work, accountability and equitable compensation".

By defining the Level of Work and CEO accountability, the board is defining the level of innovation, risk, and breadth of decision authority it is delegating to the CEO.

For example, if the organization is an income trust (e.g. real estate, oil and gas) for shareholders, and focuses on maximizing quarterly dividend payouts, it requires only a **level 1 process innovator CEO role** (see Figure 1). There is no expectation of capital investment for innovation in new products, services, and businesses. In this case, the CEO's key accountability is to maximize earnings and cash flow from the existing asset base. The focus is on operational leadership, and the decision-making authority granted by the board is for short-term core business process efficiencies to maximize quarterly EPS and return on invested capital. Given that the CEO role is in the operational leadership domain, it should be paid commensurate with this level of complexity, innovation and decision-making authority over assets.

Contrast this with a **level 5 global business/societal innovator CEO role** (e.g. BP, Unilever, Procter and Gamble, Nestle, Alcan) in a global entity operating in three or more industry sectors, with over thirty business unit presidents accountable for investing in new products and new business models in more than forty countries. The CEO role is accountable for the following:

- The next quarter's earnings per share and return on invested capital from existing operations (operational domain), and
- Two- to ten-year growth, profit, and return on risk-adjusted capital from investments in new products and businesses (business development domain), and
- Envisioning and making ten-year-plus investment decisions in R&D to create future industries (e.g. hydrogen energy, genomics, food from plant protein to feed the world) and manufacturing plant location decisions that will drive sustainability of the enterprise for shareholders/pensioners, and
- Contributing Cash-Value-Added[2] to worldwide society today and ten to twenty years into the future.

Compensation for a CEO role operating at this level of work complexity and creating long-term value should be 16 to 32 times greater than that of the income trust's CEO. Thus, different levels of CEO work, each adding unique value and requiring a different level of executive capability, provide the defensible basis for different levels of CEO compensation.

In my Accountability and Level of Work audits I frequently find the following:

- Too many layers of management compressed into the same Level of Work.
- Significant title creep.
- Executive management compensated at a strategic level but doing operational work (therefore overpaid).
- Disconnects between:
  - financial accountability and reporting systems reviewed by external financial auditors, and
  - managerial accountability, delegation and decision

authority systems across the enterprise, which are rarely audited.

Level of Work principles provide an empirically proven set of tools and processes to define work, accountability, and decision-making authority, and ensure each level adds value for customers and shareholders. This establishes a defensible basis for equitable internal compensation and how much more the CEO role should be paid than direct reports and reporting roles once removed. Current practices (using an industry model, medians, and averages for peer groups to compare compensation when CEO roles operate at significantly different levels of work complexity and true accountability) result in overpayment for the less complex CEO roles and underpayment for the more complex CEO roles.

Level of Work can help minimize the ratcheting effect that current compensation benchmarking practices have created. First, within industry sectors, boards and shareholders need to compare executive compensation levels relative to the estimated Level of Work at comparative companies to determine defensible compensation. Research suggests that each CEO level is worth two times the level of work directly below it. Example, a level 3 business model innovator CEO role is worth two times more in total direct compensation than a level 2 new product / new service innovator CEO role.

Second, where industry sample sizes are too small, boards need to include peripheral industry sectors for benchmarking and matching of executive roles and compensation at the estimated SAME Level of Work in these other industries. This shifts compensation benchmarking from an industry-based model to an employment model. This type of comparison also follows the trend in the recruiting of executives across industry sectors. The bottom line, executive accountability and pay-for-performance frameworks need to be sound and defensible to shareholders, employees, courts and the broader societies who provide a license to operate.

Having addressed the problem of measuring and designing executive work, accountability, and defensible executive compensation, let us now turn our attention to the second measurement challenge, how the board can measure the success of the enterprise

Beyond Quarterly Earnings Per Share

"The quarterly earnings per share (EPS) game has little to do with running a business, and the numbers can become distracting and dangerously detached from the fundamentals," says Barry Diller, CEO of Interactive Corporation (formerly USA Interactive).

The boards, CEOs and CFOs of Coca-Cola, Gillette, Nordstrom, McDonald's, Mattel, AT&T, Progressive Insurance, and PepsiCo have stopped providing quarterly EPS guidance. Yet many analysts and the business media continue to focus on short-term EPS, stock price, and total shareholder return (TSR) as key measures of business performance and leadership success, even though there can be no correlation between the economic fundamentals of the business and stock price within a one- to five-year time horizon.

The companies who refuse to play the quarterly guessing game can move away from short-term earnings management and financial engineering. Instead they can focus on achieving the right balance among short-term operational stretch goals, medium-term (two to ten-year) investments in new products and services, and new business models that create sustained value for customers, shareholders and societies. Importantly, these companies are changing their accountability structure to focus on leveraging resources to meet short-, medium- and long-term goals concurrently. Successful strategies are not executed in three-month periods—consider Enron, which met EPS targets for sixteen consecutive quarters before they hit bankruptcy.

The boards, CEOs and executive teams at companies such as BP, Unilever, Alcan, NovoNordisk, Procter & Gamble are creating enterprise models for sustainability, corporate and social responsibility, and global citizenship that go far beyond the current year's earnings per share and return on invested capital. They have each embraced a ten-year-plus mission, purpose, and strategy to use shareholder capital to create sustainable value for societies. These and other companies have established

triple-bottom-line measure of success (financial/shareholder, environmental, societal/community).

If boards are to carry out their "duty of care and good faith" to shareholders, as outlined in recent court decisions, they must transform current board practices for executive selection and executive compensation. Executive pay for performance must move from maximizing short-term EPS and stock price, to optimizing the creation of shareholder value and societal Cash-Value-Added in the three-to-twenty-year-plus planning horizons.

The Board's Accountability / Capability

Newly identified board governance processes and checklists will not solve the current accountability and measurement problems in executive compensation and management structure. How, then, can a board address this challenge? Should it take a defensive posture, hoping the problem will disappear over time, or should it dig in deep to assess and address the root cause? One hallmark of leadership is the ability to turn a crisis into an opportunity, and how each board responds to this crisis will be a measure of its leadership.

A critical board function is to define the CEO role's Level of Work and leadership accountability. Yet this board function is not clearly defined in any of the best practice principles, processes, or check lists for corporate governance from the Conference Board, Canadian Coalition on Good Governance, or the International Corporate Governance Network. Recent court decisions in favor of shareholders (Disney in the US, Repap in Canada) highlight the importance of a defensible process for boards in making executive compensation and executive selection decisions. The business judgment rule no longer provides a loophole for directors to neglect their duty of care—they will be held to account and required to demonstrate a defensible decision-making process.

The governance implication of defining the Level of Work and CEO leadership accountability is that, to truly add value and represent shareholder interests, the Board of Directors must have a collective capability to operate at the same level as, or ideally one level of work higher than, the CEO role's defined level. Thus there are also five levels of board accountability and matching requisite capability that match the five levels of CEO accountability described in the figure that accompanied the first part of this article. There are four possible relationships between the capability of the Board and CEO (see Figure 2*)*.

Figure 2: Board/CEO Capability Matrix

	CEO – Operating Below Required Capability Level	**CEO +** Operating at or above Required Capability Level
Board + Operating at or Above the Required CapabilityLevel	**CEO Driven Shareholder Risk**	**Shareholder Value Creation** *("the leadership challenge")*
Board – Operating Below the Required Capability Level	**Shareholder Value Destruction**	**Board Driven Shareholder Risk**

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As many of the recent business failures have demonstrated, there is a significantly higher risk of a write-down of shareholder equity when:

- Board/CEO levels of work are not aligned with each other and the external business environment.
- Board/CEO level of work is defined at too low a level of innovation and too short a time-span for planning and results.

Syd Finkelstein's recent book, Why Smart Executives Fail, provides a number of examples of well-known business failures, many of which can be explained by misaligned board/CEO level of work accountability and capability (see Figure 2, lower left quadrant).

The size and risk of recent business failures and multi-billion-dollar shareholder write-downs could have been significantly reduced or prevented if the boards and key executives in these firms had been held accountable for the right level of work, and operating at the requisite matching level of executive and board capability.

The implication is that all Boards are not created equal. The time and skilled knowledge required of a for a level 1 Board providing oversight to a level 1 process innovator CEO is exponentially less complex than a level 5 Board providing oversight to level 5 global business/societal innovator CEO. This suggests that a Director could effectively sit on 12 to 16 level 1 Boards but only 1 or 2 level 5 boards. Jack Welch when he was CEO at GE recognized this and never accepted an outside directorship.

This also has implications for the compensation of directors and boards. A Director of a level 5 Board should be compensated 16 to 32 times more than the Director of a level 1 Board. But current Board compensation practices don't take into account theses different levels of complexity of board work and focus more on the size of the enterprise in determining director compensation.

Level of Work, as an organizational and leadership framework, has far-reaching implications that cannot be addressed here. These include pension and mutual fund manager performance measurement; the role of the board and institutional investors in large acquisitions; optimal organizational structure for the enterprise and total number of levels required; required board capability and Director nomination; optimal CEO tenure; enterprise succession planning; recruitment; competency development; business school curriculum; and management development and required career experiences to create the next generation of business leaders.

To restore investor confidence, boards, CEOs, institutional investors, regulators, and the courts need to apply a defensible and proven framework for measuring levels of work complexity and accountability and linking them with pay for performance. Board Directors who apply Levels of Work and these proven principles and tools for accountability design and talent management will shift from simply fulfilling their fiduciary role to actively participating in creating long-term shareholder value. Then, and only then, will transparent, defensible board decisions regarding CEO selection, CEO succession planning and executive compensation become reality.

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(Endnotes)

[1] Level of Work and related Stratified Systems Theory is an integrated and comprehensive set of principles, processes and rules that links organizational structure to individual ability and talent management. Each Level of Work provides a unique output that contributes to creating value for customers and shareholders. These work levels also provide the building blocks for assessing and developing general managers. Contributors to the original research, upon which our research was developed, included Elliott Jaques, Wilfred Brown, David Billis, Ralph Rowbottom, Gillian Stamp, Warren Kinston, and others.

[2] Cash-Value-Added defined by Unilever in their 2002 Corporate and Social responsibility Report, as Cash-Value-Added = cash paid to employees + governments + capital providers + suppliers + cash contributions to local communities + investments in the business for future growth