ESADE MBA Business Review

Analyzing & Showcasing
the Thoughts of Tomorrow's
Business Leaders

Corporate Governance

A FOCUS ON CEO COMPENSATION & BOARD OF DIRECTORS' APPOINTMENT AND REMUNERATION

EMBR03

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Letter from the Dean

Let me welcome you to this first edition of the annual ESADE MBA Business Review (EMBR).

I distinctly remember, late last year, when we had our Christmas cocktails with our MBA students, an enterprising 1st Year student came up to me and spoke passionately about an innovative idea he was working on; an idea to analyze and showcase the thoughts, values and beliefs of tomorrow's business leaders – that is, today's MBA students. The topic he wanted this inaugural issue to be based upon was Corporate Governance.

As he mentioned this to me a smile appeared on my face, it wasn't a smile of pride or joy or even disbelief, but one of contentment. I told myself that this student had been a part of the ESADE MBA for only four months and yet already the ESADE culture and values had started rubbing off on him.

At ESADE, we firmly believe that innovation and entrepreneurship, accountable management and socially responsible corporate behaviour are key elements for creating social wealth. We try to incorporate these values in our culture here –and the EMBR, which we believe stands for ethics, innovation, leadership and the future, is a great reflection of the values we try to impart at our School.

Today, nearly eight months after my first introduction to this idea, it gives me great joy to see it turn into reality, taken up from the stables of innovation to the highest levels of execution. It is truly innovative and its global nature is reflected not just in the diversity but also the quality of the participation.

The ESADE MBA Business Review is an ambitious yet humble attempt to showcase to the world the thinking of MBA students globally and I hope that you will enjoy reading it as much as our students enjoyed working on it during the last eight months.

Xavier Mendoza
Dean
ESADE Business School

Founder's Note

What is the ESADE MBA Business Review

'What do you call 1000 MBAs at the bottom of the ocean - A GOOD START'.

I read this MBA joke along with plenty more on the Internet during the first couple of months of the first year of my MBA late last year. This wasn't the only thing I was reading - I regularly came across an umpteen number of articles in newspapers and business magazines that commented and talked about MBAs. Some were good and some were bad. But the point was there were a lot of people who were continuously talking about MBAs - and talking about how MBAs think.

That's when I felt - enough! Enough about what the world talks and thinks about MBAs, it's time to see how and what MBAs really think.

And this is how I came upon the idea of analyzing and showcasing the thoughts, values, beliefs and attitudes of today's MBA students - tomorrow's business leaders - giving birth to the ESADE MBA Business Review: a journal that aspires to be, in the years to come, the barometer of the opinions, values and beliefs of today's MBA students and tomorrow's leaders.

To this end, we invited MBA students from business schools globally to submit papers on the topic of Corporate Governance with a focus on the compensation of CEOs and on the appointment and remuneration of the Board of Directors. It is our hope that these papers, collectively, would serve as a reflection of their thoughts, values and beliefs. Moreover we backed this process with an innovative Tri-Axial Value Study[1] of the participants. With the combined analysis of the submitted papers and the Tri-Axial Value Study, we hoped to capture some of the sentiments of MBA students globally.

We received a tremendous response to our concept and had about **200 MBA students coming from 27 business schools spread over 5 continents and 13 countries participate in the inaugural edition of the ESADE MBA Business Review.** Out of all the papers received our panel of experts chose the 10 best entries to be published in this edition, but our analysis of the thoughts and beliefs of the MBAs was based upon all the papers received.

Thus in this issue you will find two things: the analysis of our panel of experts, who have analyzed the thoughts, values and beliefs of MBAs globally and have tried to give a glimpse of any underlying commonalities and you will also find in this issue the 10 best papers that we received from MBAs globally on these topics within the field of corporate governance.

The insightful conclusions that our experts drew on the opinions, values, sentiments & beliefs of MBAs led to two interesting articles by them in this year's issue of the journal: the first article gave rise to the question **whether business schools globally are instilling values in their MBA students to 'Make a Life or Make a Living'**, and the second which on the basis of **the trends that seemed to emerge begged the question if this is 'The beginning of a new era in corporate governance - or is there still time'.**

In addition to our analysis, you will also find plenty of interesting ideas here on the issue of corporate governance from the papers published. They vary from the proposal of 'total team work' in decision-making to rotating groups of employees in the Board of Directors or even about how corporate governance is only about equilibrating all forces within an ecosystem of power. Some even suggested setting CEO salaries based upon company morale or even on the energy level in the company...

Thus the ESADE MBA Business Review is an annual journal that will invite MBA students globally to submit a paper on a relevant topic of that year. And via these papers (and any additional studies) we will analyze and showcase their thoughts, values and beliefs and subsequently try to compare it to the results of the previous years to see the evolution of the thought processes of MBA students graduating each year.

So whether you want to see how tomorrow's business leaders are thinking or what are their beliefs or simply want some insightful ideas on corporate governance, I am sure that you will find this journal extremely interesting, intriguing and informative.

If you have any questions, suggestions, comments, critiques (or if after reading this issue you feel that I and 999 more MBAs at the bottom of the ocean is a good start!) then do email me (d.sanghvi@esade.edu). This is only our first issue and we would love to have all your feedback.

Kind Regards,

Darpan Sanghvi
Founder, ESADE MBA Business Review
d.sanghvi@esade.edu

1 Explanation of the tri-axial value study can be found in the article by Prof Simon Dolan inside.

HOW ARE TOMORROW'S BUSINESS LEADERS i.e. TODAY'S MBAs THINKING?

ANALYZING THEIR THOUGHTS, VALUES, BELIEFS AND ATTITUDES

'Making a Life or Making a Living'

What values are today's Business Schools instilling. Analyzing their thoughts, values, and beliefs from an HR Perspective

BY **PROFESSOR SIMON L. DOLAN**

Based on the analysis of the papers submitted by the various participants and the value study conducted, I am writing this article which will try to provide an insight on the thoughts, values, beliefs and opinions of tomorrow's business leaders i.e. today's MBAs.

Despite the fact that all papers were supposed to address a common theme (i.e. corporate governance), it was interesting to note that the papers were very different in their style, while not so different in content and focus. Given the great geographical and cultural diversity of the schools and the teams, one would have expected to find a great disparity in content and ideas, but, it is noticed from the papers that the academic approach in the vast majority of the business schools leads to more convergence of ideas than to divergence. There were a few exceptions though like the case study in specific reference to a local culture. The question arises: are business schools throughout the world converging into a single mind set? From what I read out in the papers, this seems to be the pattern. This is not necessarily wrong, especially in the aftermath of the Enron or WorldCom scandals; a heightened level of consciousness to issues of social responsibility is interwoven in most papers along with traditional corporate goals for profit and productivity maximization. It was interesting to note that similar tendencies are also reflected in the results emerging from the "Tri-Axial Value Study" that was done in parallel and is briefly summarized hereafter.

One of the recurrent themes in corporate governance had to do with CEO compensation schemes. It has been evident by reading the papers that human resources and especially strategic HRM is not been treated sufficiently in most MBA programs. Consequently, I am not surprised to see that the vast majority of the papers did not apply nor consider strategic HR issues in advancing arguments and theories about CEOs compensation schemes. The papers that addressed this issue, dealt mainly with formulas and explicit policies for remunerating CEOs, as it is an important issue in corporate governance in the 21st century firm. However, strategic executive compensation is a complex phenomenon and if poorly implemented implications can and will be felt throughout the entire organization. If there's little doubt that the Corporate World is doing something right by linking pay more closely to shareholder value, however, it's also clear that greed has its limits. Despite the anecdotal connection, no academic has proven that higher pay creates higher performance. While self-interest is, as Adam Smith observed centuries ago, a great motivator, the link between pay and any objective standard of performance has been all but severed in today's system. The options windfall is as likely to reward the barely passable as the truly great; moreover, it's rewarding virtually one and all in amounts that are expanding almost exponentially.

THE QUESTION ARISES: ARE BUSINESS SCHOOLS THROUGHOUT THE WORLD CONVERGING INTO A SINGLE MIND SET?

I wish to make a reference to what I consider one of the fascinating questions arising from the different approaches to corporate governance and is based on explicit or implicit MBAs values. That's one of the lessons business schools are unwittingly passing along to students. Indirectly, the papers land an interesting perspective of how the students' view the role that business plays in society, and how their business-school experience has shaped that view.

Previous research (Wharton Survey 2001) proposes that students who had started their two years of graduate school thinking that a company's top priorities were customer needs and product quality said that by the time they graduated, their own top priority had shifted to "shareholder value." They also said they did not feel it was possible to change a company's values, and that, faced with a stressful conflict, they would simply leave the firm (study by the Aspen Institute's Initiative for Social Innovation Through Business, The Wharton School, 2001).

Results such as the above provided the impetus to the questionnaire based analysis of values amongst MBA business students. This study was based on a Tri-Axial Values Model.

Tri-Axial Values Model

The essence of the model suggests that in order to survive and remain competitive in the 21st century turbulent environment, firms need to optimize its various resources in order to simultaneously satisfy its multiple stake holders. The model thus proposes that the task of future leaders will be to strike an intelligent balance in achieving economic, emotional and ethical objectives. Firms that will have the capacity to reengineer this type of culture will survive in the 21st century. Given that the probability of moving from the actual state (mission) to the future state (vision) depends on a great extent on the motivation of the workforce to commit, we need to better understand the value structure and to shape it so it is congruent with the strategic objectives of the firm.

The values selected to measure The Work Values Structure were:

1. Economic Values	2. Emotional Energetic Values	3. Ethical Social Values
Efficacy	Creativity	Happiness
Efficiency	Growth	Friendship
Economic success	Enthusiasm	Conscientiousness
Productivity	Imagination	Companionship
Results	Hopefulness	Dignity
Competitiveness	Equity	Honesty
Fulfilling objectives		Tolerance
		Respect
		Work-life enjoyment

The Values Selected to Measure the Life Values Structure were:

1. Economic Values	2. Emotional Energetic Values	3. Ethical Social Values
Efficacy	Creativity	Happiness
Efficiency	Growth	Friendship
Economic success	Enthusiasm	Conscientiousness
Productivity	Imagination	Companionship
Results		Dignity
		Honesty
		Tolerance
		Respect
		Collaboration
		Hopefulness
		Passion
		Respect of people
		Faithfulness

Based on the results of the study of these values, various Tri-Axial Value Pictures are formed. On the following page is the global Tri-Axial Value Picture for Work and Life values. A look at the picture will give a better understanding of the Tri-Axial Value Model and will facilitate a better understanding of the results of the study that are outlined further in this article.
The primary objective of the study was to identify the underlying value structure at work and life amongst MBA students and supplement our qualitative analysis of the papers submitted by the various teams and thus on their basis identify various MBA schools who adhere to a specific value system (i.e. philosophy with which a special emphasis

STRATEGIC EXECUTIVE COMPENSATION IS A COMPLEX PHENOMENON AND IF POORLY IMPLEMENTED IMPLICATIONS CAN AND WILL BE FELT THROUGHOUT IN THE ENTIRE ORGANIZATION

is placed on corporate governance). Some of the general conclusions of the Tri-Axial Value Model study include the following points:

- By and large MBA students (regardless of the school they are enrolled or the geographical location) accord as much importance to economic values as to ethical and emotional values in their work sphere. This is coherent with the mission and vision statement of many MBA schools who assert that they wish "to develop outstanding business leaders who will contribute to the well-being of the firm by also embracing values of integrity, honesty, mutual respect and accountability".
- By contrast, MBA students accord relatively less importance to economic values in their life sphere (compared to work sphere).

Placing the teams from the Business schools according to order of dominance of certain clusters/dimensions of values, the following results were found:

- The teams from Anglo-Saxon business schools accord higher importance to economic values (i.e. efficiency, result orientation, productivity) than the teams from the central European business schools.
- The teams from Instituto de Empresa (Spain) and London Business School accord relatively the highest importance to ethical-social work values while the teams from the central European business schools (SIMT and Solvay) shows the least importance to these work values.
- In relative terms, the school expressing the highest importance to emotional-energetic values was the team from London Business School in the U.K., and by contrast, the school expressing the relative lowest importance to emotional values in work context was the team from New York University – Stern Business School.
- In reference to the importance of economic values in life spheres, the London Business School team expressed the highest importance while the central European universities as well as Arizona expressed the least importance.
- Ethical-social values in Life of the highest importance were noted for teams from Kenan-Flagler Business School, University of North Carolina (US) and Melbourne Business School (Australia), while teams from neither the German school (SIMT) nor Stern (N.Y.U) accorded importance to these life values.

Analysis also revealed some interesting characteristics based on the country where the students are pursuing the MBA. For example:

- The teams from the commonwealth business schools accord importance slightly higher than the mean for most work and life values; although they score below the mean for life emotional-energetic values; Emotional values are the most important of the three in work context, but ethical-social values are the most important in life context
- The teams from the various Chinese business schools systematically score above the mean for all value dimensions. Nevertheless, important differences (i.e. incongruence) can be implied by observing the differences especially between the economic and ethical-social value dimensions; Economic values dominate the work agenda but not life as much.
- Teams from the Indian Business schools score slightly higher than the mean on almost all dimensions , and a high level of congruency between work and life values is also manifested.

- The teams from the Mediterranean schools (Spain, Italy) score around the mean for the economic values at work settings, but significantly below the mean for the importance of economic values in life. By contrast, ethical-social values seem to be important in both work and non-work settings and thus these schools score slightly above the mean on this dimension (emotional values for the teams from the Mediterranean are relatively more important in work settings than in life settings).

THE SCHOOL EXPRESSING THE HIGHEST IMPORTANCE TO EMOTIONAL-ENERGETIC VALUES WAS THE TEAM FROM LONDON BUSINESS SCHOOL IN THE U.K., AND BY CONTRAST, THE SCHOOL EXPRESSING THE RELATIVE LOWEST IMPORTANCE TO EMOTIONAL VALUES IN WORK CONTEXT WAS THE TEAM FROM NEW YORK UNIVERSITY – STERN BUSINESS SCHOOL

- The teams from the US business schools score very slightly above the mean for all work related values (economic, emotional and ethical) as well as for ethical-social life values. However, they score below the mean in attributing importance to economic values in life context, and slightly below the mean for emotional life values. While certain congruency is manifested for importance of emotional and ethical values in work and life context, incongruence is observed for the economic values in the latter.

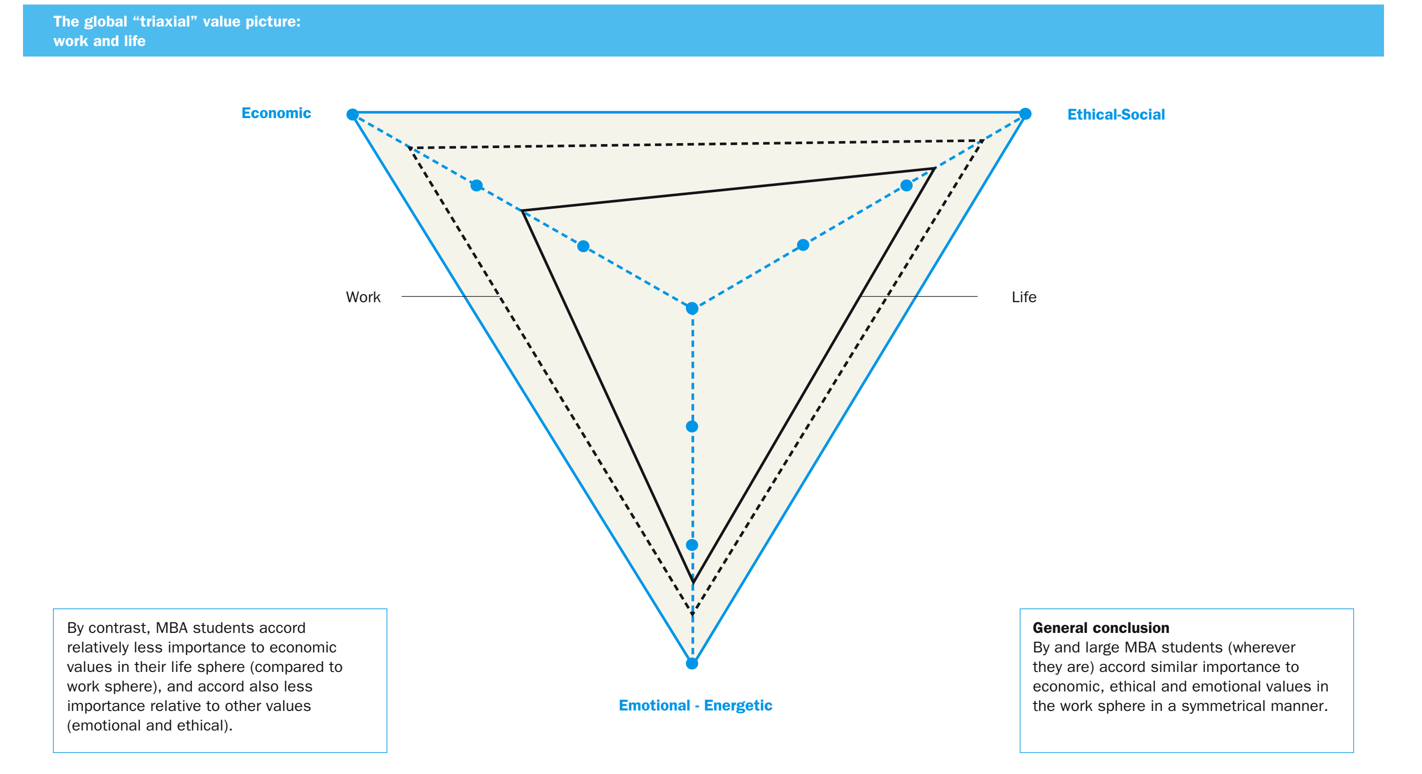
Concluding Remark

Most business schools today strive to develop leaders who have not only mastered the principles of general management, but also exhibit the above values in their actions. The modern business schools in the 21st century consider this so fundamental that they emphasize these aspects in their academic curriculum. Based on the papers submitted and the value survey, it appears that there is greater awareness to emotional and ethical-social issues today than in the past. The agenda of MBA students seems to be broadened in work context, but it is interesting to note that there is no corresponding attitudes/values for life spheres thereby leading to future conflicts between work and life demands and making the strive to achieve a balance between these two spheres of life very difficult. The results of the analysis of the papers and the questionnaire based study suggest that **life values are almost always lower that work values**. Does that mean that work is more important than private life for professionals such as MBAs? Or does it mean that perhaps we had not included the real important values for private life in this study?

Taking the risk of interpreting my conclusions as a cliche, I wish to end my commentary by a phrase:

Are MBA Schools instilling values that prepare one to "make a life or make a living"?

The global "triaxial" value picture: work and life



The author, Professor Simon L. Dolan was part of the panel of experts of the ESADE MBA Business Review. He obtained his Ph.D. from the Carlson Graduate School of Management at the University of Minnesota. After a long academic career in the U.S. and Canada, he joined ESADE and holds a Chair in HRM and is currently the Director of research of IEL (Institute for Labor Research). He has written 24 books in HRM /OB themes (in three languages: English, French and Spanish) and over 90 articles and book chapters appearing in leading management journals.

‘The Beginning of a New Era - or is there still time’

Analyzing the opinions of the MBAs on Corporate Governance and aligning the trends that emerge with Corporate Strategy

BY **PROFESSOR MIGUEL TRIAS & PROFESSOR J. BRUNAT**

Corporate Governance – remuneration and the role of top management - has been the issue for debate of this first ESADE MBA Business Review. On these lines we will connect the papers to present the general trends that emerge and then use these trends to present a perspective on Corporate Governance aligned with a Corporate Strategy point of view.

PARTICIPATION TO SEND IN PAPERS ON THIS TOPIC HAS COME FROM MBAs STUDYING IN BUSINESS SCHOOLS SPREAD ACROSS USA, EUROPE, ASIA, AUSTRALIA AND AFRICA

Corporate scandals of 2001/2002 have demonstrated that Corporate Governance is one of the hottest topics of corporate regulation globally. This is reflected by the fact that participation to send in papers on this topic has come from MBAs studying in Business Schools spread across USA, Europe, Asia, Australia and Africa.

While in closed corporations the suppliers of funds (concentrated ownership of capital and financial institutions) have a tight control over corporate assets, in Publicly Owned Corporations (POC) such control relies much more in open contracts and principal-agent structures. In these structures, public trust in disclosed information and management is essential.

POC are dominant in the US, UK and other countries with well developed capital markets, but their weight in Continental Europe has grown a lot during the last two decades of XXth century, due to privatisation and access to capital markets of family owned companies. Economies in development such as India, China and South Africa still rely much on State action and concentrated ownership. But likelihood is high that their greater companies will follow a similar trend than Continental European ones.

Therefore, concern about the events happened in Enron, Global Crossing, WorldCom and others is general and irrespective of geographical locations.

THE IDEA THAT GOOD CORPORATE GOVERNANCE SYSTEM IS NOT ONLY A MORAL CLAIM, BUT ALSO AN ECONOMIC NEED WAS ANOTHER IMPORTANT TREND THAT WAS NOTICED

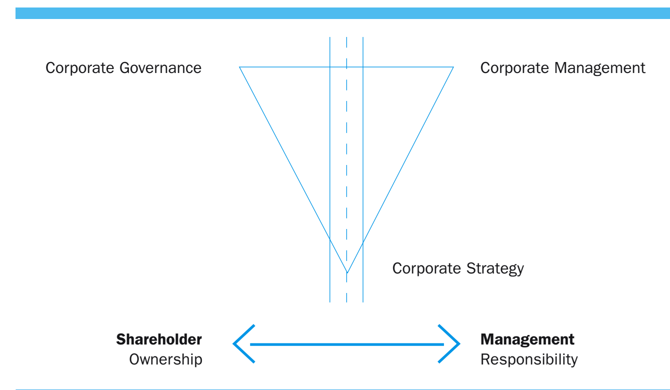
From our joint analysis of the works presented, we identified some trends that were common in most of the papers submited whilst presenting their opinions (of the MBAs) on this topic of Corporate Governance:

- There was a deep concern for the levels of management compensation, which seem to be excessively high, especially in crisis context, when the company is laying-off workers and announcing losses – This is especially interesting because these were the thoughts of top MBAs, who sometime in the future are expected to be in the top levels of the management.
- A general idea that was very strongly shared was that management compensation system based on stock option plans as they are currently designed generates short term approach and perverse incentives.
- There was a sense of agreement that an adequate design of management remuneration packages is essential to align management performance to long term strategic goals. Bonus schemes based on objectives, rights that are vested in the medium to long term and an adequate design of stock option plans were just some of the numerous different methods proposed to duly offer incentive to the management.
- The conception that the board of directors is the key intra-firm constituency is general. Due assumption of its responsibilities and adequate selection of its members are needed in order to determine the main strategic goals of the corporation and to implement a system of incentives of management which is in line with such goals.
- Strong management is needed, but the power of CEO must be balanced. Separation of CEO and Chairman of the board posts seemed to be a common claim.
- The idea that good corporate governance system is not only a moral claim, but also an economic need was another important trend that was noticed. Corporations with adequate corporate governance will produce higher returns and will show better valuation in the stock markets.
- A general lesson that seems to stem from many of the papers is that a right analysis should not only focus on one of the pieces of the system. All agents have their role: managers, directors, auditors, lawyers, analysts, investment bankers, institutional investors, and each one must share their part of responsibility.
  The role of each of them must be re-evaluated. At the same time, although most of the corporations implied have their headquarters in US, though most of them are multinationals and the problems arisen seem to be systemic, an international approach seemed to be needed.

Aligning the Trends with Corporate Strategy

Post the *dot.com crash*, corporate and financial scandals, auditing and accounting fiascos, have served the purpose of warning signals of the, until now, mainstream way of thinking, of the management disciplines.

Trying to build a link between the different approaches to the area of Corporate Strategy, and taking into account the rich views and arguments exposed, a first conceptual framework is envisioned.



Although the model does not imply a proportional positioning of these concepts, it certainly tries to locate proximity to *process-owning agents*. General agreement can be found in the following ideas;

- The way companies are managed and positioned must be controlled and guided in a way it reflects shareholders' (the ownership) interests and values (Corporate Governance?).
- Companies continuously search for value generating advantages in order to achieve sustainable and higher returns on their available resources, frequently combining multi-business capabilities and competencies (Corporate Strategy?).
- Decision making variables arrange all *components* in such a way that will exploit, with the highest effectiveness, their *value-capture* capabilities (Corporate Management?).

A COMMON FEELING IS SHARED IN THE PAPERS WE RECEIVED THAT A CERTAIN MODEL HAS BEEN EXHAUSTED, AND POSSIBLY, A DIFFERENT STYLE OF MANAGEMENT IS EXPECTED

These three drivers make us draw the dotted line allocating responsibilities to both sides; those bearing the ownership (the principal - shareholders and its direct representatives, i.e. the Board, Management Council, ...), and those employed to run the operation (the agent - the CEO and the rest of responsibility bearing directors and managers).

Alignment between both parties is a requirement that is neither natural nor granted. This phenomenon is frequently identified as the *principal - agent conflict*.

Corporate Strategy decisions possibly are the most relevant configuration moves companies can design and implement for value capture in the long run. Misalignment between agent and principal will reduce the perceived value capture capabilities and very likely destroy value on a longer term.

Why can this happen? What we are now detecting can be called the time - value dilemma. Which is the time span in which corporations should assess its value generating results?

To add a new dimension to the complexity: *the value - vector consideration*; how to measure the value generated?

Financial and accountancy based ratios and measurements? A more complete triple bottom line concept including economic profit, and social and environmental value/impact? A multidimensional approach (Value for; 1. Shareholders, 2. Employees, 3. Suppliers, 4. Customers and Society, and 5. The Company itself)?

More variables into the equation and additional considerations of no less importance:

- CEO compensation
- Shareholder type and needs

WHAT WE ARE NOW DETECTING CAN BE CALLED THE TIME - VALUE DILEMMA. WHICH IS THE TIME SPAN IN WHICH CORPORATIONS SHOULD ASSESS ITS VALUE GENERATING RESULTS?

Considerations that have proven stronger relationships and ties to the discussed issues than expected. Fairly volatile owners (i.e. Capital market stocks) are constantly looking for higher returns that have a positive impact on the share value, and therefore ask for this management style. It seems that top management compensation has shifted from fixed and stable, to variable schemes, trying to align these volatile owners' expectations with the corporate strategies and management.

Can this be one of the main reasons for giving these issues a much different impact when observed in stable - ownership, privately owned and family owned, and even government owned companies?

A point of disruption has been reached when Corporate Governance and CEO Compensation have gone from controlling and aligning to conditioning and defining Corporate Strategies. Although the effect has been of re-channelling value and profit in a very effective way, back lashing effects have been extensive in coverage and enormous in size.

The news unveiled one of the most visible consequences of all this in May 2003 in the USA; the "global settlement" reached between the Securities and Exchange Commission and ten investment banks. An almost $1.4 billion fine, which possibly is only of symbolic measure if the real dimension was to be sized, and the curious fact that no prosecution will be carried out, or criminal charges presented in the case.

A POINT OF DISRUPTION HAS BEEN REACHED WHEN CORPORATE GOVERNANCE AND CEO COMPENSATION HAVE GONE FROM CONTROLLING AND ALIGNING TO CONDITIONING AND DEFINING CORPORATE STRATEGIES

Wrapping it up; the depth and reach of Corporate Strategies should at least be known by main stakeholders of companies. Faulty Corporate Governance, and misguided Corporate Management, can and will lead to the abuse of this discipline and management tool, certainly having consequences that cannot be understated. The differentiated roles of owners and managers call for transparency, communication and common understanding, and whenever new incoming owners can substitute outgoing ones, further openness and shared ethics are required.

A common feeling is shared in the papers we received that a certain model has been exhausted, and possibly, a different style of management is expected, especially in companies subject to the conflicts identified. However it is not clear enough in this first edition of the ESADE MBA Business Review that this is the beginning of a new era – though there are some traces that suggest it might not be too far away.

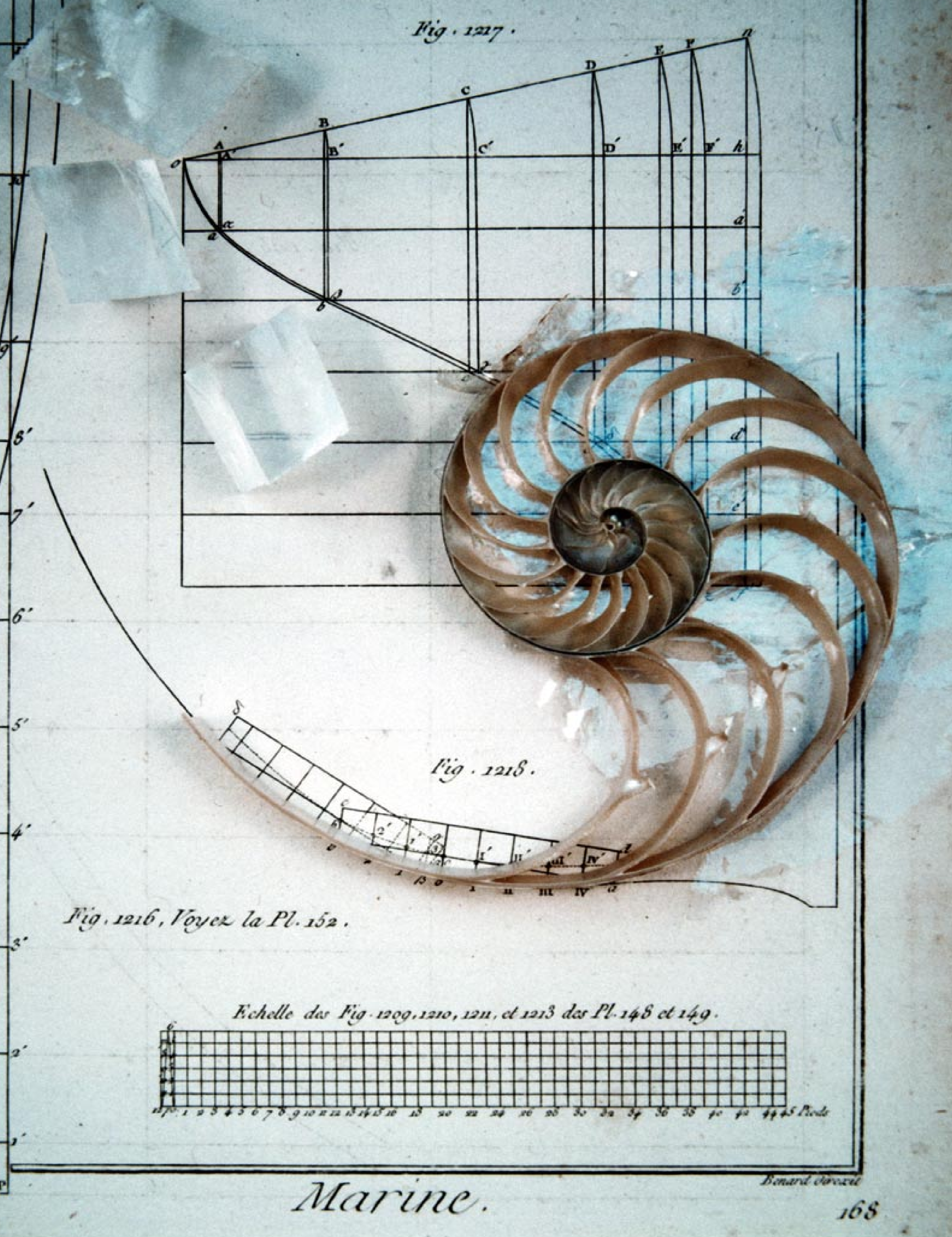
The two authors were a part of the panel of experts for the ESADE MBA Business Review.

Professor Miguel Trias holds a Doctor of Law from the University of Barcelona and an ESADE MBA. He is a Partner at Landwell – PwC in the Barcelona office leading the practice of M&A and Commercial Law. He has been Non executive Chairman of the Board of directors of FILO - a Real Estate quoted company. He has written several articles on Corporate Governance and Commercial Law appearing in many leading journals.

Professor J. Brunat is an Industrial Engineer from UIA (Mexico) and an ESADE MBA. His experience includes being member of the Executive Committee of Volkswagen-Audi España, Director of Corporate Development and Owned Subsidiaries, and Director of Marketing Services in the same company. He has been member of Nissan Europe's Marketing and Product Committees. Currently he is the Director of ESADE's Executive MBA Program and is a Professor of the Business Policy Department.

HOW ARE TOMORROW'S BUSINESS LEADERS i.e. TODAY'S MBAs THINKING?

2. SHOWCASING THEIR THOUGHTS ON CORPORATE GOVERNANCE WITH A FOCUS ON CEO COMPENSATION & THE BOARD OF DIRECTORS' APPOINTMENT AND REMUNERATION



BEST ENTRY OF THE YEAR

THE MARSHALL SCHOOL OF BUSINESS, UNIVERSITY OF SOUTHERN CALIFORNIA (USA)
BY STEVEN W. HUANG, GILBERTO GUTIERREZ, JOSEPH LIN

Seeking a new paradigm:

Corporate Governance in the aftermath of the United States' corporate crisis

Introduction

Within the last two years, corporate scandals have rendered one-time industry juggernauts such as Enron and Tyco, icons of corporate greed. We believe these scandals are directly related to companies' failures to (1) align CEO compensation packages with their shareholders' interests and to (2) appoint and reward boards of directors in a manner conducive to long-term success.

In order to align CEO's interests with those of shareholders and motivating directors to carefully hire and monitor CEO's, we recommend two compensation schemes. First, we propose tying board of directors' bonuses to CEO performance. Second, we propose basing CEO's bonuses on non-budgetary measures and other performance standards outside of management's control.

Appointing and Rewarding the Board of Directors

Courts have long held that directors have a fiduciary duty to act in the best interests of the corporate entity and its shareholders. (Stanley, Brad and Don Whitney 1986). Accordingly, the board's role is to monitor management for the shareholder's benefit. (Elson, Charles, Paul Helms and James Moncus 2002). Modern corporate governance theory advocates equity ownership and independence as mechanisms to motivate the board to actively monitor corporate management. (Elson, Charles M., Paul M. Helms and James R. Moncus 2002). This approach's weakness lies in identifying the appropriate amount of ownership. On the one hand, motivation will be minimal if stock ownership is insubstantial. (Elson, Charles, Paul Helms and James Moncus 2002). On the other hand, lavish stock options may motivate

managers to boost near-term share prices and ignore long-term consequences. (Lerach, William 2002).
The pinch of this puzzle lies in eliminating equity ownership altogether. We propose compensating directors with a base salary and a performance-based bonus. Salaries will deliberately be set below the industry average.

However, the bonus will give directors the opportunity to earn more than their competitors' total compensation packages. Bonuses will be awarded if the company's stock price (1) rises by a certain percentage and (2) stays at that level for an extended period of time. The following is a sample stock price appreciation-maintenance plan:

		Days at New Levels			
		1 month	**3 months**	**6 months**	**12 months**
Stock Price Growth	150%	$150,000.00	$165,000.00	$180,000.00	$195,000.00
	100%	$100,000.00	$115,000.00	$130,000.00	$145,000.00
	50%	$50,000.00	$65,000.00	$80,000.00	$95,000.00
	0%	$0.00	$0.00	$0.00	$0.00

For example, a director will receive a $50,000 bonus if stock price appreciates and is maintained at 50% for one month. The director will receive $65,000 if the price stabilizes for 3 months, $80,000 for 6 months and $95,000 for 12 months. The goal is to award larger bonuses for greater percentage gains that are maintained for extended periods of time. Since we assume that companies will not be able to sustain stock prices over long periods of time if they are supported by nefarious conduct, boards of directors will be encouraged to act as ethically as possible.

WE PROPOSE BASING CEO'S BONUSES ON NON-BUDGETARY MEASURES AND OTHER PERFORMANCE STANDARDS OUTSIDE OF MANAGEMENT'S CONTROL

To motivate directors to actively monitor CEO performance, companies will reward only half of the bonuses every year. The other half will be stored in a trust account, payable only when the director leaves the board. The trust account will bear an interest rate, higher than the prime rate whenever the stock price stays constant or grows. However, when the stock price drops, an independent governance consultant will be retained to determine whether the reduction was due to the CEO's actions. If the CEO was primarily responsible for the reduction, then the effective interest rate will fall below the prime rate. If the reduction was not attributable to the CEO, then the accounts will continue to bear the same prime plus premium interest rate. Thus, directors will be highly motivated to carefully hire and monitor CEO actions, thus reducing incentives for corporate wrongdoing.
To further these goals, a staggered appointment system should be used to replace only a small percentage of the board every year. This will encourage stability and ensure that retiring directors' incentives will be counterbalanced by non-retiring directors' incentives. Additionally, potential directors should be screened during the appointment process for their ability to encourage independence and team play as well as to objectively monitor management. The following traits would be desirable:
1 Team attitude;
2 Ability to assume roles ranging from devil's advocate to supporter;
3 Detailed understanding of the company's business;
4 Willingness to limit participation in other boards;
5 Absolutely no business relationships with the company itself; and
6 Ability to supplement the current board's skills.

A STAGGERED APPOINTMENT SYSTEM SHOULD BE USED TO REPLACE ONLY A SMALL PERCENTAGE OF THE BOARD EVERY YEAR

Compensating the Ceo

The crux of the CEO compensation problem lies in the imbalance between stock options and incentive schemes. Many skeptics have criticized options because they motivate managers to boost short-term share prices at the expense of long-term consequences. (Robert 1998; Elson, Charles M., Paul M. Helms and James R. Moncus 2002; Yablon, Charles 1999; Yablon, Charles M. and Jennifer Hill 2000). However, stock options are useful because they tie executive compensation to the firm's profitability, increase management's appetite for risk by instilling a proprietary interest in the company and minimize turnover rates. (Johnson, Eric 2000). Therefore, we propose a CEO compensation package comprised of a base salary, a structured bonus, a pay-performance structure, and stock-based incentives.

Benchmarking Base Salaries to Industry

Most companies use competitive benchmarking to compute base salaries for CEO's. (Murphy, Kevin 1998). Benchmarking consists of deriving a CEO salary from a combination of industry salary surveys and a detailed analysis of industry or market peers. (Murphy, Kevin 1998). We see no need to depart from these well-established and effective norms. (Murphy, Kevin 1998).

SEASONED BUSINESSES SHOULD EMPHASIZE COMPANY MORALE AND CUSTOMER SATISFACTION. EMERGING COMPANIES SHOULD FOCUS ON THE PERCENT CHANGE IN THEIR STOCK PRICE WITH THOSE OF THEIR COMPETITORS

Structuring CEO Bonus Compensation

Bonuses will be based upon performance measures, performance standards, and an entrepreneurial pay-performance structure. To ensure long-term performance, companies should employ a minimum of six performance measures. These measures are:
1 Percent change in company stock price;
2 Percent change in company stock price in relation to change in competitors' stock prices;
3 Company morale;
4 Customer satisfaction;
5 Company profitability; and
6 Company resource efficiency in relation to industry resource efficiency.

Most of these measures were chosen because they are not related to budgeting activities and are outside of managements' control. Managers are more inclined to be profit conscious and less inclined to engage in gamesmanship when these measures are used. (Bart, Christopher 1988). With less incentive to engage in budget gamesmanship, CEO's will be more inclined to align their interests with shareholders' interests. (Bart, Christopher 1988).

Companies should assign varying weights to each measure according their corporate objectives. Seasoned businesses should emphasize company morale and customer satisfaction. Emerging companies should focus on the percent change in their stock price with those of their competitors. A brief description of each measure and standard follows.

Percent change in company stock price. Assuming that stock prices reflect all publicly available information, a company's financial strength is reflected in its stock price. (Ross, Stephen, Randolph Westerfield and Jeffrey Jaffe 2002). The performance standard would be to compare the company's stock price at the end of the fiscal year with that of the beginning of the fiscal year. Generally, rising stock prices should be interpreted as positive signs; falling stock prices are negative signs.
To this end, companies should consider using the following formula to calculate stock price bonuses:

Stock Price Bonus =
(Target Bonus) + [(Y%) x (ROR – ROR^{I}) x (BSP)][2]

This formula specifically awards CEO's for meeting and exceeding target expectations. The target bonus relates to a predetermined award for meeting a percentage increase in stock price. A CEO will receive the bonus if the stock price meets the target percentage. The CEO will not receive the bonus if the stock price fails to perform accordingly. ROR and ROR^{I} relate to the company's rate of return and the industry's rate of return, respectively. BSP is the company's stock price at the beginning of the fiscal year, and Y% is a previously agreed upon percentage that will compensate CEO's for any stock price appreciation over and beyond the target percentage.

Percent change in company stock price versus change in competitors' stock prices

Every firm's success depends on how it contends with its competitors. (Kapon, Alan 1987). Accordingly, a CEO's bonus should reflect how the company's stock price fared against those of its competitors. By averaging competitor stock prices, one can create an industry trend, which will help evaluate the CEO's performance. This phenomenon is best explained by the following example.

THIS MEASURE WILL PRESSURE CEOs TO CLEARLY COMMUNICATE COMPANY GOALS TO EMPLOYEES AND FOSTER EXCEPTIONAL WORK ENVIRONMENTS

Many companies would be pleased with their CEO's actions if their stock prices grew by 40% in a year. However, those same companies may not be as pleased if their competitors' stock prices grew, on average, by 100% during that same year. Conversely, many companies would logically be disappointed if stock prices dropped 40% in a year.
These companies, however, must look beyond stock prices. External factors may have caused the entire industry to suffer. If the firm's competitors averaged an 80% drop in stock price, then the firm's 40% reduction may be noteworthy. Indeed, the stock price may have dropped even further but for the CEO's efforts. The CEO should be rewarded accordingly.

[2] This article's authors would like to thank Professor Kevin Murphy of the University of Southern California for his contributions and assistance concerning the equations referenced in this article.

Company morale

It is well known that productivity rises when morale is high. (Nelson, Bob 2003). Accordingly, companies should reward high company morale. This measure will pressure CEO's to clearly communicate company goals to employees and foster exceptional work environments.
The standards for this measure will be based on:
1 The company's turnover rate compared to its competitors;
2 Annual, company-wide evaluations of the CEO's performance; and
3 Exit interviews.

Near the end of every fiscal year, employees will have the option of completing an evaluation of their CEO. Additionally, every employee that resigns from the firm will have the option of completing an evaluation as part of their exit interview. The evaluations will then be analyzed and used to determine part of the CEO's company morale bonus. If company morale is at an acceptable level, the CEO will be rewarded. Otherwise, the CEO will not be rewarded.

A COMPANY THAT CONSISTENTLY FAILS TO SATISFY ITS CUSTOMERS WILL HAVE TENUOUS LONG-TERM PROSPECTS. ACCORDINGLY, A CEO'S BONUS SHOULD BE BASED, IN PART, UPON CUSTOMER SATISFACTION.

Customer satisfaction

One of the clearest measures of a business' success is its ability to satisfy its customers' needs. A company that consistently fails to satisfy its customers will have tenuous long-term prospects. Accordingly, a CEO's bonus should be based, in part, upon customer satisfaction. Although the standards for this measure will be largely company and industry-specific, firms should consider objective factors like the percentage of deliveries made on time and customer retention rates.

Company profitability

The bottom line is profit. If a company cannot generate profits in the foreseeable future, then its future will be very limited. Accordingly, part of a CEO's bonus should be based on profitability. Companies should designate a percentage bonus for the difference between net income and return on assets. The equation would be as follows:

Customer Profitability Bonus =
X% (Net Income – ROA)

Company resource efficiency in relation to industry resource efficiency

Finally, CEO's should be rewarded for operational efficiency. Higher operational efficiency will lead to higher levels of production. The following equation would be useful to calculate rewards:

Resource Efficiency Bonus =
X% x [(ROA – ROAC) x (Assets)]

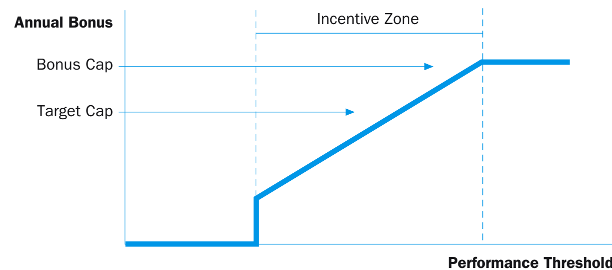
X% relates to a previously agreed upon percentage bonus. ROA refers to the company's return on assets, ROAC is the competitors' return on assets and Assets pertain to those belonging to the company itself.

Additional Performance Measures

In addition to the aforementioned performance measures, companies should analyze the values reflected in their mission statements. If their values are not reflected in the recommended performance measures, then companies should create additional performance measures to align their CEO's incentives with their mission statements' values.

Replacing the Conventional Pay-Performance Structure

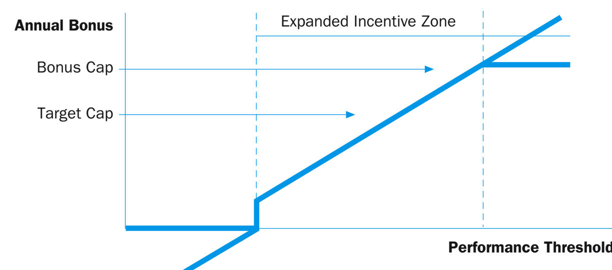
Many CEO compensation plans are structured as follows:



Under this plan, a company will pay a CEO a bonus only if the CEO achieves a minimum level of performance. (Murphy, Kevin 2001). Larger bonuses will correspond to greater levels of performance, until performance reaches a previously designated limit. (Murphy, Kevin 2001). At that point, bonuses will be capped. (Murphy, Kevin 2001). The range between the minimum bonus level and the cap is known as the "incentive zone." (Murphy, Kevin 2001).

Pay-performance structures fall short of motivating CEO's because they encourage mediocrity. CEO's with performance levels far below the incentive zone will have little incentive to improve their performance if the chances of reaching the incentive zone are unlikely. (Murphy, Kevin 1998). Conversely, CEO's capable of exceeding the threshold cap will be motivated to withhold effort and save their earnings for use in a subsequent year. (Murphy, Kevin 1998). Additionally, we believe that exceeding the threshold cap may actually raise expectations and hurt them in subsequent years. Accordingly, CEO's will exert only enough effort to fall within the incentive zone. The result has been mediocrity over exceptional performance.

These concerns can be alleviated by altering conventional pay-performance structures in the following manner:



This plan also incorporates a clearly defined incentive zone. However, it treats performance outside of the incentive zone differently. For performance that exceeds the bonus cap, CEO's will receive a previously designated percentage of the firm's profits. This will eliminate any incentive on the CEO's part to restrict his/her performance and, instead, motivate the CEO to perform to the best of his/her ability.

For performances below the minimum threshold, companies will retain an independent compensation consultant to determine whether the failure was due to external factors or the CEO's actions. If the CEO was responsible for the failure, then the company should withhold its bonus and reduce the CEO's salary. If the CEO was not responsible for the failure, then the company should award the CEO the bonus he was entitled to (based upon the aforementioned performance measures) and maintain the CEO's salary.

PAY-PERFORMANCE STRUCTURES FALL SHORT OF MOTIVATING CEO'S BECAUSE THEY ENCOURAGE MEDIOCRITY

Adjusting Stock-Based Incentives

As indicated earlier, stock-based incentives received much criticism during the recent slew of corporate scandals. Although stock-based incentives may motivate some to influence stock prices, no contract will perfectly align managers' and shareholders' interests. (Bebchuck, Lucian and Jesse Fried and David Walker 2002). Yet, stock-based incentives have powerful benefits, as they tie executive compensation to firm profitability and increase management's appetite for risk by instilling a proprietary interest in the company and minimize turnover rates. (Johnson, Eric 2000). Accordingly, our scheme includes stock-based incentives.

We base the amount of incentives to be rewarded upon company morale and customer satisfaction. Company morale and customer satisfaction are key measures for financial success. Improving employee satisfaction results in happier customers, which then leads to higher financial results. (Rikleen, Lauren Stiller 1998). Additionally, we believe they are sufficiently removed from the CEO's direct control to buffer any motivation for nefarious conduct. In short, if company morale and customer satisfaction reaches previously designated levels, then CEO's will receive some level of stock-based incentives. If the expectations are not met, then CEO's will not receive the incentives.

ALTHOUGH STOCK-BASED INCENTIVES MAY MOTIVATE SOME TO INFLUENCE STOCK PRICES, NO CONTRACT WILL PERFECTLY ALIGN MANAGERS' AND SHAREHOLDERS' INTERESTS

Conclusion

The primary concern of this article has been to propose a new method of aligning management and shareholders interests. To this end, two broadly defined actions are important: (1) board members should be motivated to carefully monitor CEO's performances and (2) CEO's should be receive bonuses based upon metrics that are as adulteration-proof as possible. In this manner, corporate governance can become a safeguard against the type of nefarious conduct we have recently witnessed, while ensuring that shareholders earn a maximum return.

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THE GRADUATE SCHOOL OF BUSINESS, UNIVERSITY OF CHICAGO (USA)
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Maintaining equilibrium:

The Power Ecosystem

Power **is dynamic** —
a fluid ecosystem, organic, in motion, alive,
breathing, round, experienced, intangible, in vivo.

Power **is not linear**,
quantifiable, monetizable,
containable, uniform, in vitro.

Assessing the level of power a CEO needs requires understanding how much power a CEO has. During the recent flurry of corporate wrongdoings, political figures, the popular press, and academic theorists advocated for systems to curtail CEO power. A CEO, however, is but one creature within a fluid ecosystem of power. Born out of the complex relationships within and outside of a firm, this ecosystem can naturally reach — and maintain — an equilibrium in which CEO power is balanced with the power of her constituencies. This essay will demonstrate that the mechanism for balancing CEO power is already in place. How much power a CEO has is reflected by how far, and in what direction, this ecosystem diverges from its organic state. How much power a CEO needs is the amount that will bring the ecosystem to its equilibrium.

The exchange of value between and among different organisms — vital inter-firm and intra-firm constituencies — catalyzes the flow of power within the ecosystem. (Please see page 35 for a diagram of the power ecosystem.) Intra-firm constituencies include the Board of Directors, Senior Management, Employees, and Shareholders; inter-firm constituencies encompass Government, Local Community, Creditors, Customers, Suppliers, and Media. The constituencies, the firm itself, and the CEO are not autonomous; each entity functions both collaboratively and competitively with others. The relationships that evolve can be symbiotic, in which two organisms benefit from each others' presence and are unable to survive independently; parasitic, in which one organism (the parasite) is benefited and the other (the host) is harmed; or mutualistic, in which two organisms benefit from each other, but can still live independently.

In furthering their individual interests, constituencies trigger movement within a living network, and power cascades either toward or away from the CEO. Fluid bonds between constituencies and the CEO ripen the environment not only for disproportionate power and parasitic relationships, but also for power equilibrium. To illustrate how power is balanced within the system, the following section explores each constituency's interests, its instruments for attaining those interests, and how power is ultimately balanced with respect to the CEO.

Intra-Firm Constituencies

Within the firm, the key power constituency with respect to the CEO is the Board of Directors. The central task of the Board is to oversee the CEO, the CEO's management team, and the company itself – paying close attention to the firm's productivity, and thus the personal profitability of shareholders and Board members. The Board's ability (through majority vote) to hire and fire the CEO – often to further its own (and shareholder) interests – renders it more powerful than the CEO. The Board's monitoring influence is perhaps the most significant intra-firm force within the ecosystem, contributing to equilibrium potential.

TRUTH IS, FOR ALL THE GROUSING ABOUT CEO MALFEASANCE, SHAREHOLDERS DESERVE A GOOD DEAL OF THE BLAME THEMSELVES FOR THE CURRENT CORPORATE MESS

Similar to the Board of Directors, Senior Management is also concerned with the success of the company, from an operational perspective. Senior Management, however, is more personally invested – that is, the success of the company directly impacts this constituency's bonus and/or compensation. Senior Managers are primarily focused on day-to-day operations of the company and their role within it: maintaining their employment status, managing their own career success, ensuring employee satisfaction, and/or having adequate resources.

Because Senior Management serves as conduit between the CEO and employees, its influence is simultaneously up and down the corporate ladder. While the CEO relies on Senior Management for expertise on function-specific operations of the day-to-day business, Senior Management has the ability to distort information down while disseminating information to subordinate employees.

The power relationship between CEO and Senior Management depends on whether the CEO came with or put in place his own management team. If the CEO has hired individuals who have shown consistent

loyalty to him, Senior Management morphs into the CEO's power base within the organization. The dynamic between a CEO and Senior Management is also shaped by how much expertise a CEO has in the various management team members' arenas, as the CEO may defer to Senior Management. Because the CEO is ultimately accountable for firm decisions (even those advised by Senior Management), however, a CEO may utilize his weight to overrule Senior Management. Virgin CEO Richard Branson, for example, may not be an expert in all of his ventures, so he hires industry-specific gurus to direct the operations of individual businesses, such as airlines or music. Because his senior managers may have a deeper understanding of Virgin's operations, the CEO may have less authority over decisions. At the same time, Mr. Branson's name and face are always attached to any news about Virgin's ventures.

While the CEO can dismiss members of Senior Management, Senior Management must collaborate with another constituency, the Board, to overthrow the CEO. Because personal loyalty, professional accountability, specific expertise, and potential gains coalesce in this relationship, the CEO and Senior Management are symbiotic — each benefit's from the other, and in most cases, each cannot exist independently.

FUSING WITH OTHER INTER-FIRM CONSTITUENCIES, PARTICULARLY THE MEDIA AND THE GOVERNMENT, INTENSIFIES THE POWER LOCAL COMMUNITIES AND PUBLIC INTEREST GROUPS HAVE WITH RESPECT TO THE CEO

For intra-firm constituencies that have less direct contact with the CEO, power is almost categorically concentrated with the CEO; this imbalance of power derives from the constituency's overall diminished interest and influence over the welfare of the company. Employees have very little loyalty to their company, and even less if they do not own stock in the company. Their motivations are highly personal and individualistic — salary, vacation days, benefits, and quality of work/life. To gain influence or have their voices heard, employees must band with inter-firm constituencies, such as the Media or Government. In Germany, however, where most employee groups have been unionized, a union representative sits on the Board, increasing employee voice. In this paradigm, because employees are privy to all major decisions and have voting rights, power shifts away from the CEO. Without representation on the Board or by a union, however, employees have little to no power with respect to the CEO.

Of the intra-company constituencies, Shareholders may have the least interest in the company's well-being, focusing instead on short-term gains — making a "quick buck." Recognizing the need to cater to "the people", some CEOs work hard to generate and maintain shareholder excitement. As such, Shareholder opinion can influence the CEO to make changes. Additionally, organizations aimed at protecting shareholder interests, such as Calpers, further tame CEO power with respect to shareholders.

> Truth is, for all the grousing about CEO malfeasance, shareholders deserve a good deal of the blame themselves for the current corporate mess. It was institutional investors, shareholder advocates, and corporate raiders who make 'maximizing shareholder value' the prevailing principle of American business. Through the 1980s and 1990s rump in CEO pay, you hardly heard a peep from shareholders, as long as they got theirs.[3]

While most shareholders have the option to vote on company changes, they usually do not exercise the option, thus lessening their structural power to influence firm decisions. When shareholders are not comprised solely of "the people", however, this constituency can have a great deal of influence. For example, when Hewlett-Packard CEO Carly Fiorina suggested a merger with Compaq, Walter Hewlett, a relative of the company's founders and majority stakeholder, tried to prevent it. While Fiorina ultimately executed the merger, Hewlett was able to spark debate — and curtail CEO power — for almost one year.

Inter-Firm Constituencies

The Government's capacity to regulate the corporate arena — and to collect corporate income tax — shapes the power of a CEO; antitrust law, regulatory agencies, and employment policies all affect how a CEO operates within the national environment. Insofar as it is charged with protecting the interests of those whose well-being is affected by corporate decisions, such as employees or shareholders, the State has the muscle to undermine CEO power. At the same time, in furthering the national strategic interest, the State may fortify CEO power to achieve aligned goals, as evidenced by policies to promote GDP growth, enhance military services, and ensure access to raw materials.

In certain governments, however, specific industries have the opportunity to transform their economic weight into political clout — that is, corporate entities, through strategic lobbying and generous donations can modify either the law itself or how it is applied to them. While a CEO can challenge the State, rarely can a CEO fully subvert governmental control. For example, when Vivendi CEO Jean-Marie Messiers fired CEO and founder of a Vivendi subsidiary, Canal+, the move generated such outrage that the French government, along with major shareholders, intervened to have Mr. Messiers removed. Because a CEO must adhere to a given set of laws, then, power is ultimately balanced with the State.

As an inter-firm constituency, the Government not only has power with respect to the CEO, but it also has the power to allocate power. Public Interest Groups and Local Communities, for example, can severely pressure CEO decision-making by leveraging their clout with the Government, along with other inter-firm constituencies like the Media. Committed to increasing corporate citizenship and social responsibility on both the local and global levels, community activists and public interest groups are vital elements of the power dynamic. By generating excitement about how corporate decisions impact nearby businesses, employment rates, or environmental health, Local Communities and Public Interest Groups become funnels through which CEO power can be diluted. A Local Community, for example, may be able to limit a firm's entry or expansion into a given market. Fusing with other inter-firm constituencies, particularly the Media and the Government, intensifies the power Local Communities and Public Interest Groups have with respect to the CEO.

The CEO is exceptionally vulnerable to the media, which shapes how the public — including other constituencies — perceive individuals within the business sector. Because the written/spoken word is understood by many as categorically truthful, media portrayals can profoundly boost or impede CEO power. Indeed, the media is one of the few constituencies that, when furthering its own interests (e.g. gaining readership, advertising dollars, public recognition), can manipulate not only the formal, but also the charismatic, power of the CEO. That is, in crafting a qualitative spin of a CEO, the media generates either affinity or disgust for the CEO as a person, thereby enhancing or thwarting his power with respect to readers — other constituencies.

3 John A. Byrne, "Investor Power has its Downside, Too," *Business Week*, July 1, 2002.

At the same time, as Jack Shafer wrote in a recent Slate.com column about media bias, "the media is big business, owned outright by General Electric, Murdoch, Disney, Cox, Bertelsmann, AOL Time Warner, Microsoft, Knight-Ridder, Viacom, Gannett, et al."[4] Just as the media can shape CEO power, the CEO can utilize the Media to further his own power. Ultimately, however, because it has the ability to expose corporate missteps, the Media exerts more power over a CEO.

In their contracts with individual firms, Suppliers and Creditors generate power, compelled by developing their own business. Depending on market size, demand, and differentiation of supplier good, Suppliers may have tremendous bargaining power with respect to the CEO. Creditors, on the other hand, wield even greater power than Suppliers, since the firm is first and foremost indebted to its creditors. Additionally, because a Creditor can shape CEO reputation and destroy CEO access to capital in the future, creditors can exercise broad power with respect to the CEO.

Customers, on the other hand, are primarily concerned with ensuring access to low-price, high-quality products. Their function of purchasing and setting trends renders them a core power, but only en masse; if exercised strategically, customers can be potent.

The weight of an individual customer, however, is negligible, with respect to the CEO.

The Power Equilibrium

> The ruling power within, when it is in its natural state, is so related to outer circumstances that it easily changes to accord with what can be done and what is given it to do.
> Marcus Aurelius, *Meditations*

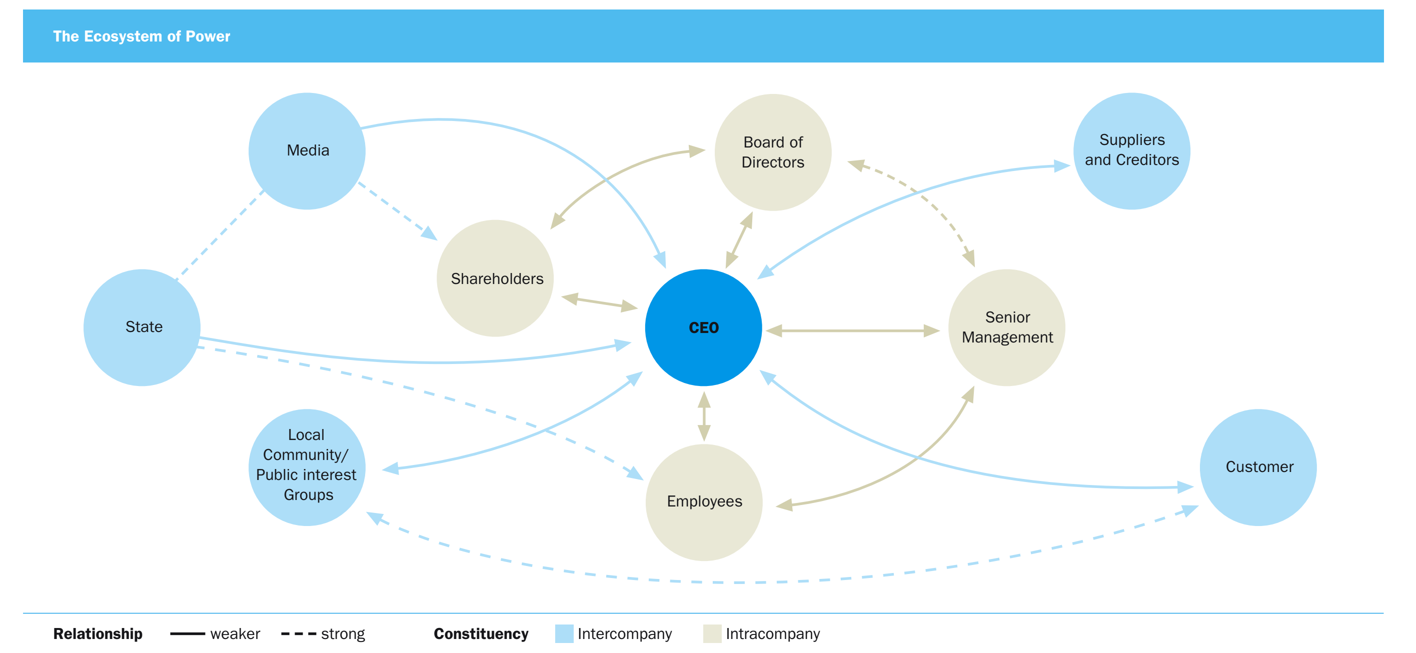
When the ruling power — the CEO — is in its natural state, it is vulnerable to — and morphs with — outside forces. Both inter-firm and intra-firm constituencies have the capacity to curtail or enhance CEO power. While the relationship each constituency has with the CEO may not be symmetric, all power does not emanate from the CEO.

When each organism works to further its own interests, the system comes closer to reaching equilibrium. Constituencies that have the highest level of power with respect to the CEO (the Board of Directors, the Government, and the Media) compensate for those constituencies that have low levels of power with respect to the CEO (Employees, Customers).

When assessing how much power a CEO needs, then, one must question how effectively each inter-firm and intra-firm constituency is controlling CEO power. Each influence exercised by a constituency, or a group of constituencies, can balance CEO power. The notion that CEO power is infinite may therefore be unwarranted, as when each constituency functions within the ecosystem, CEO power is impacted. Only when constituencies either neglect their interests or fail to utilize their influences is the power ecosystem in disequilibrium. To maintain equilibrium, then, CEO power must be considered holistically, with respect to how other constituencies function within this relationship. The power a CEO, then, is not about compensation structures or corporate governance; it is about equilibrating all forces within an ecosystem of power.

4 Jack Shafer, "Bias in the Media: Part I", *Slate.com*, February 5, 2003.

The Ecosystem of Power



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CHINA EUROPE INTERNATIONAL BUSINESS SCHOOL, SHANGHAI (CHINA)
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The agency problem in Corporate Governance

Costs, Challenges and Suggested Responses; The role of the Board of Directors and Executive Compensation

I. Introduction

It is in the nature of things that political news often makes bolder headlines than economic news. Thus it was not surprising that the tragic events of 9/11 or the current Iraq crisis should have attracted wide comment. And yet the spate of adverse news heralding the ignominious collapse of publicly-owned icons such as Enron was in a way equally devastating. On the one hand, hundreds of thousands of investors lost their savings overnight. On the other, the string of implosions seemed to have snapped[5] the cord of confidence tying millions of investors to the large publicly-owned companies (POCs) a link responsible, in part, for ushering in the modern era of prosperity in the US, and elsewhere.[6]

We begin with a review of the agency problem . A case is made for separating the corporate governance crisis from the dot.com bubble: we claim that investors bear less blame for the former[7]. Next we examine the role of the Board of Directors (BoD) and executive (CEO) compensation in the present crisis. In parallel, we disagree with the pro-market school of reform[8] and believe that Sarbanes-Oxley was both needed and fairly comprehensive.

Four central threads run through the paper: First, the problem of corporate governance is complex and the solution proposed must consist of well-integrated and inter-locking parts. Second, three elements of the whole system of governance stand out: the BoD, executive compensation and outside auditors; and the first is vital for the reform of the last two. Third, there is an imminent and overriding need for transparency in information reporting.[9] Fourth, no one should ignore the rest of the world - for reasons of space we discuss only China.[10]

EVEN IF SOME INVESTORS WERE OVERTAKEN BY GREED, WHY SHOULD OTHERS BE PENALIZED?

II. The Agency Problem

To begin with, the dilemma lying at the very heart of the current crisis was recognized by Adam Smith, and later by Berle and Gardiner, who argued that the wide dispersion of shareholders would increase management's power, thus leading to agency costs.[11] Consequently, over the years, a whole system of corporate governance evolved, including a BoD, auditors, analysts, stockholder supervision and ultimately the threat of voting out the board, a hostile takeover or selling by the shareholders.

This model of managerial capitalism worked well in the last century, albeit twice necessitating government intervention by Roosevelt, resulting in the proliferation and strengthening of large POCs, leading to prosperity in the US and elsewhere. Consequently, it is important to keep in mind that an overreaction can be as damaging as no action.

However, in the 1990s, as ownership became increasingly diversified, shareholder oversight, already fragile, further weakened. Second, as the marginal individual tax rate on dividends became higher than the one on capital gains, dividend payout fell, putting the spotlight on stock price and earnings, and then on CEOs to meet short-term increased expectations.[12]

The BoD, meant to be an oversight body by virtue of its positions of propinquity and legal authority[13], simply fell by the wayside. Two developments, both contextual and consequential, further aggravated the crisis. As the dot.com bubble[14] began its meteoric growth, precariously perched on a dubious business model, and whipped into frenzy by avaricious investors and opportunistic investment bankers, the pressure on CEOs suddenly became manifold. In addition, helped by silent BoD and auditors, CEO compensation both soared and became increasingly opaque. In turn, the very structure of compensation further deepened the crisis.

Thus when Enron capsized, many initially blamed a few rapacious corporate officers and auditors for the spectacular developments.

To be sure the CEO, the CFO and even the BoD of Enron may have set new standards in corporate avarice. But it was no more a question of a few people being overwhelmed by voracity: the whole structure of corporate governance was proving inadequate.

Equally important, while investor greed was a key factor behind the dot.com bubble, it would be unfair to blame investors in the present cri-

5 In July 2002 alone, investors withdrew USD 49 billion from stock mutual funds, according to NYT (Anderson, "After the fall" pwcglobal.com).

6 "We could not have achieved our current level of national productivity if corporate governance had been deeply flawed", Alan Greenspan, address at Stern School, NYU, March, 2002.

7 For a counterview, see Joseph Nocera, System Failure, Fortune June 9, 2002. We think he is mixing two distinct events.

8 Troy Paredes, "Enron...and Congress" February, 2003 (Washington University) "I place my bet with the more flexible market-based approach", p 29.

9 The Global Investor Opinion Survey by McKinsey in July 2002 found overwhelming support for financial disclosure (mckinsey.com/governance). And transparency requirements also include putting the information on the net in user-friendly languages (such as HTML and not PDF).

10 We will see that while some issues are common (BoD effectiveness), others are dissimilar (CEO compensation) while still others are specific to China.

11 Berle and Gardiner, The Modern Corporation and Private Property (1932), pp 69-70, 87-89. In fact, Rousseau, in Social Contract, pre-empted the agency problem by noting that voters were free to elect representatives only on the day of elections.

12 Greenspan's op.cit address.

13 "Business of every corporation shall be managed by or under the direction of a Board of Directors"; Section 141(a) of the Delaware General Corporation Law.

14 In the well-documented and equally thoroughly-ignored tradition of bubbles such as the Tulip mania, the South Sea and the Railways in the US in the 19 century.

sis. Very briefly, investors are scattered, and are faced with the Olson's free-riding dilemma. In addition, the costs of and hurdles in mounting an effective campaign against a sitting board or management can be prohibitive[15].

Further, if a question mark hangs over the very ability of the Enron board to understand complex transactions, how can investors be expected to oversee dealings of similar complexity? And, if large institutional investors such as CALPERS can run oversight systems, this in itself might create a new agency problem[16]. Finally, even if some investors were overtaken by greed, why should others be penalized?

THE BOD, MEANT TO BE AN OVERSIGHT BODY BY VIRTUE OF ITS POSITIONS OF PROPINQUITY AND LEGAL AUTHORITY, SIMPLY FELL BY THE WAYSIDE

III. The Board of Directors

It is our deep conviction that no reform of the current corporate system can succeed unless the institution of the BoD is renovated and rekindled[17]. Consequently we find it surprising that there is some resistance to the idea of a more active board: some fear that the hand of the CEO would be tied down; others opine that the BoD would spend too much time on its oversight role.

Let s go back to the deafeningly silent role of Enron s BoD. For years the management, especially its CEO and CFO, cut deals which egregiously flouted both norm and law the CFO was often on both sides of a financial transaction.[18] And the whole strategy of Enron now seems like a pyramid scheme. Yet investors would know only when the stock came crashing down.[19]

This leads us to the role of the BoD, which is essentially to act as a guide and monitor (including overlooking nomination, succession and compensation) of the management and as the principal selector and watchdog of the external auditors. Of course the BoD can neither run the organization nor double-check management s decisions. But it must ensure that when the long-term interests of the investors are compromised at the altar of short-term benefits it puts its foot down.

Similarly, the BoD must ensure that transparency is maintained, financial statements are prepared in accordance with prescribed rules, proper outside auditors are selected and rotated[20], management compensation is based on fair criteria, and the overall business strategy does not spin out of control. In fact, a good CEO would be relieved to work with a conscientious BoD there is no room here for megalomania or narcissism[21].

III.1 Suggestions

1. The majority of members of the BoD must be independent[22]. To be sure, non-financial - structural, social and cognitive - biases can affect individual behavior. But a non-independent BoD cannot assume the kind of role we are talking about. Thus the definition of independence must be made more detailed[23] and the criteria adhered to strictly.
2. All large POCs beyond a certain size should be required to separate the position of the Chairman from the CEO as the conflict of interest is fraught with too many dangers to be ignored.
3. It is essential to select the best available members. In particular, financial literacy has risen to the top of the criteria. Additionally, all directors must periodically submit themselves both for training, especially on Anomalies in financial data , and evaluation.
4. Top finance professors must form an important part of the reservoir from which directors are to be selected, subjected to the same constraints as other directors. It is hazardous to assume that professors would be less likely to yield to financial temptations.
5. The Board should also consist of directors who bring in diverse and needed skills, whether in the field of accounting, marketing or strategy.
6. CEO s say in the selection of the Board will only compromise the BoD s independence.
7. Directors must devote their time, energy and commitment to the increasingly strenuous work, in light of recent legislation[24]. Gone are the days when directors could sit on dozens of boards. All other directorships should be disclosed. Similarly, interlocking directorships should be strictly banned.
8. There must be a limit on the tenure of directors and no extensions should be allowed.
9. Directors should NOT be paid either in short-term cashable stock[25] or in stock options. Their compensation should comprise a fixed salary, enough to attract the best in the market, and some stock which can be cashed ONLY one year after their tenure ends. No other payment of any kind should be made to them[26].
10. All the above information should be transparent and posted on the company website.

IV. CEO Compensation

Nothing has excited, inflamed and dismayed the public more than CEO compensation. What added poignancy to the debate was the CEOs enrichment even as their companies fortunes declined. Sanford Weill of Citigroup's $785 million[27] may have been exceptional. But as DaimlerChrysler, Dynergy, Tyco, WorldCom, Alcatel, Vodafone and Vivendi lost billions and as their executives were rewarded with millions, investors felt cheated.[28] And of course revelations of Jack Welch s emoluments dented the reputation of one of the greatest CEOs of the last century[29].

Strangely, much of the discussion on CEO compensation has been unfocussed. Consequently, for clarity we ask three questions: Is the current level of CEO compensation just? Is the process to set compensation perfectly market based? Has the very structure of this compensation adversely impacted corporate governance?

The answer to the first question must be in the affirmative: Much as CEO compensation may seem exorbitant, **if** the market decides upon this figure, then so be it. However, as to the second question, although more empirical research is needed[30], we believe that most probably the process in many cases was not perfectly market based.[31]

It is the third question which goes to the root of the present dilemma. We believe that both the structure (especially the now-infamous stock options) and the levels of CEO compensation were more than wasteful – they were perverse and whetted CEO appetites to go for the short-term stock rise. Intuitively, the temptation to reap tens of millions of dollars, as opposed to falling out of money, appears overwhelming.

Equally important, the way stock options were handled left much to be desired. Our leitmotif is corporate governance can only work holistically. As the BoD became quiescent, not only were stock options not expensed in the income statements but also they were conveniently re-priced. And there was no requirement on the timing of cashing.[32]. Finally, even when stocks rose merely on the back of a rising tide of the index itself, CEOs made fortunes.

IV.I Suggestions

1. All stock options must be expensed immediately. The argument that it was difficult to do that never held water – Coca Cola's procedure announced last year seems reasonably valid.[33]
2. In opposition to most commentators arguing in favor of a mix of cash, stock and options as an appropriate compensation package, we remain convinced that stock options, generally speaking, at least for large POCs, are ill-advised.
3. The CEO compensation should ideally comprise fixed salary and stock-issued in part based on valid performance criteria. No loans of any kind may be offered to the CEO. The salary should be enough to attract the very best. It is of the UTMOST importance that under no circumstances should stock be encashed before one year lapses after the CEO has left the company. And a notice to the general public must be served three months before encashment.
4. All the above arrangements should be decided by the Compensation Committee consisting of independent members, and must be re-affirmed by the shareholders. Thus transparency is imperative.

AS THE BOD BECAME QUIESCENT, NOT ONLY WERE STOCK OPTIONS NOT EXPENSED IN THE INCOME STATEMENTS BUT ALSO THEY WERE CONVENIENTLY RE-PRICED

V. China

It is not possible to deal adequately with corporate governance in China within this space. But the key point we want to make is that corporate governance issues are not peculiar to North America and Western Europe. And China poses some special problems in this regard. For convenience, we separate the SOE and SME[34] levels.

At the SOE level, the listed company in the stock exchange in many cases is part of a three-tiered structure with a parent Ministry or Commission at the top and a Group Company at the middle, the entire structure with diffused and multiple ownership, often leading to interference and conflict. In addition, the profits of the listed company may go to other parts of the system. Many listed companies did not even have a meaningful track record. This explains in large part the dismal performance of the stock market in China, in direct contrast to the sparkling growth of Chinese economy in the last two decades.[35]

In addition, a host of problems beset Chinese business entities: weak incentives for managers (in direct opposition to what we saw above); unrealistic valuation of assets and exclusion of land-use rights from the asset pool; outright asset stripping, especially through joint ventures and declaring bankruptcy; ineffectiveness of banks to monitor companies; powerless BoDs (as we saw above) and shortage of well-skilled auditors.[36] Further, the limited power of courts and lawyers to provide a system of checks and balances, and protect shareholders, further constrains corporate governance.[37]

Regarding the small and medium SOEs, their corporatization "in the vast majority of cases has been accompanied by the allocation of ownership rights to insiders". Later, many distributed all of their profits as dividends, leading to considerable deterioration of their performance. This situation was compounded by lack of creditors' monitoring. In addition, local governments sometimes insisted on retaining key powers, such as the right to appoint top management. All of this contributed to managerial entrenchment. And banks, who should play a very significant role in corporate governance, have a limited influence in China, even when the debtors declare bankruptcy.[38]

Of course the Chinese Government is fully aware of this problem and is making serious efforts to set in place an improved corporate governance system. Our contention is that while we pay attention to the crisis in US and Europe, we should not wait for a new crisis to ripen in Asia and China and must strive to strengthen the hands of both national governments and institutions such as WB and IFC to pre-empt another outbreak.

VI. Conclusion

The recent events in corporate governance have almost, but not irretrievably, snapped the chord of confidence. The link can be repaired and the edifice of corporate governance re-constructed on sound footings, but only if the whole structure is supported by all its parts. As we insist again and again in the above paper, the process must be holistic: If courts reverse changes in laws and regulations, if outside auditors are allowed to change names and get away without paying compensation, if the BoD remains dormant, if CEO compensation is not reformed, if financial analysts are not held accountable for their assessments[39], if media does not play its part, if investors remain uninformed, and if we do not pay attention to regions outside North America and Western Europe, then mere reforming one or two elements would prove futile.

We owe it to the unfortunate investors and, more importantly, to ourselves, to see to it that corporate governance is put both on the business and political agenda at a place commensurate with its importance.

15 Ronna Abramson, "Voices in the Corporate Wilderness", TheStreet.com.
16 CALPERS might sell its stock on insider information, leading to worse problems for minority holders.
17 Comparisons have been merciless: "ornaments on a corporate Christmas tree" by HBS professor Myles Mace; "the boss's marionettes" by Businessweek.com/1996/48.
18 Fusaro and Miller, "What went wrong at Enron; William Powers, Report by … the BoD of Enron (2002).
19 This is why we disagree with pro-market reformers. Paredes notes "Perhaps the best indicator that markets work is the major selloff that occurred after Enron broke out." (op.cit. p 27). But by the time Enron broke out the investors were ruined!
20 We do not agree with those who question this suggestion (eg David Leslie, CEO Ernst and Young, "Remarks to the Canadian Centre for Ethics" October 25, 2002, p 8).
21 But as Paul Coombes (mckinsey.com) says there "is a tendency to interpret disagreement as disloyalty".
22 Investors in the McKinsey survey (op.cit) overwhelmingly wanted more independent boards.
23 Such as in NYSE Listing Standards.
24 OECD Principles of Corporate Governance (1999) p 44.
25 Many commentators want to issue stocak to the directors (eg Felton and Watson – McKinsey Quaterly 2002 No 4) but if directors are able to sell their stock during their tenure, surely this would only exacerbate the agency problem.
26 Coca Cola lavished on the directors retirement benefits, health and dental coverage, and life insurance (businessweek.com/1996/48).
27 "I'll pay yours if you'll pay mine", by Deborah Orr, Forbes, March 2001.
28 Julia Finch, Guardian, June 7, 2002; Richard Heller, "Let the Sun Shine In", Forbes, 9 February 2002.
29 Warren Buffet has said "the recent compensation of CEOs was the biggest peacetime wealth transfer in history".
30 Luc Renneboog's interesting research on CEO compensation (tilburguniversity.nl) Sep 2002 clearly shows we need much more empirical work.
31 "Too often investors are kept in the dark about the pay of senior executives", Richard Heller, op.cit.

32 Ellison of Oracle exercised stock options just before an earnings warning, reaping USD 706 million (BusinessWeek, May 6, 2002).
33 Gary Fayard, CFO, in www.directorship.com (September, 2002) [Coke is ecstatic to be the third company to do this – we find it surprising why it waited all these years]. Also see the long-delayed article by Bodie, Kaplan and Merton "Stock Options are an Expense" in HBS March 2003.
34 State Owned Enterprise, and Small and Medium Enterprise.
35 This para draws on lectures by the famous Chinese professor Wu Jinglian at CEIBS which we were privileged to attend.
36 This para draws heavily on the excellent report on Corporate Governance in China by Tenev and Zhang (IFC 2002).
37 Interview with John Growbowski, Baker & M., Shanghai, by Laurie Underwood, MBA Participant CEIBS.
38 ibid, chapter 3.
39 Merrill Lynch analysts recommended stocks they "privately regarded as 'a piece of shit'", Finch, op. cit.

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SDA BOCCONI (ITALY)
BY SEBASTIAN CARDARELLI, EFTHYMIS KONSTANTOPOULOS, TARUN RASTOGI

Calma Coop

"We are the founders of Calma Coop. We are three individuals who believe in the ancient sagacity of the Far East, the spirit of fraternity and equality of Europe, and the pioneering spirit of the West. We believe in committee and clarity before 'comply or explain'. We believe in self-governance before 'regulation'. We believe in stakeholders before shareholders. And we believe in 'None of us is as smart as All of us'.

The advent of the new millennium has seen radical shifts in the application of Corporate Governance (CG). In a few short years at the end of the 20th century, investor confidence went from dizzying heights to catastrophic lows. Like the story of Icarus, the extremism of the markets' rise was concluded by an equally devastating fall from glory, and in the wake of 'Enronism', governments, regulators, investors, and the general populace clamor for transparency and accountability of publicly held firms. The saga began with stock markets that spiralled upwards out of control, as long-held market values and established mechanisms for information were ignored. The bubble burst and left in its wake accounting irregularities and rampant discoveries of astonishing corporate greed. Regrettably, in society's haste to correct these crimes, the lessons of the Depression, the early 80's and the 90's were also disregarded as a spate of rash legislation and policies were proposed, adopted and enacted to curb executive misdemeanour. We think that these end results represent superficial solutions to the problems, and we believe there are basic beliefs which can better serve to address these issues in order to reinvent the roles of CEOs and Boards of Directors.

In this paper, we will outline our interpretation of CG, the trends in recent policy towards it, and how redefined responsibilities of the CEO and a Board of Directors (BoD) can improve upon some of the transgressions by these parties in the past few years. We will use Calma Coop, an organization of our own creation, as a model to demonstrate the values we believe public companies should espouse, and we will draw upon some unique real world examples to strengthen our proposals. In the final analysis, we believe that a change in corporate philosophy is required to develop a community of ethical behavior, which in turn will corral the possibilities for corruption and crime at the executive level.

At Calma Coop, we believe the best decisions are based upon consensus. Consensus is not necessarily conducive to arriving at the fastest decision, but we avow that haste makes waste. In resolving issues that affect divergent parties and conflicting opinions, it is only within the forum of discussion, debate, and dissension that coherent and effective management is actually produced. If we do not tolerate dictatorial regimes in our societies, we do not believe they should be tolerated in our companies either.

"It is not that humans have become any greedier than in generations past. It is that the avenues had grown so enormously."[40] In describing to Congress how corporations managed to 'mismanage' so pervasively, Alan Greenspan succinctly addressed the means by which these recent events transpired. CG is not a new concept, but simply one whose time had not yet come before the year 2000. And now it has arrived in earnest, with bells and whistles, yet also with some rather suspect implementations.

WE DO NOT THINK THAT ANY ONE PERSON, OR GROUP OF DIRECTORS, IS NECESSARILY BEST EQUIPPED TO DETERMINE THE OPTIMAL PLAN OF ACTION FOR ALL INVOLVED. AND THERE ARE SOME STRIKING EXAMPLES TO DEMONSTRATE HOW A TEAM ATTITUDE CAN WORK BEST. CONSIDER ORPHEUS, A CHAMBER ORCHESTRA THAT PERFORMS WITHOUT A CONDUCTOR

In 1994, a law in the US "capped deductibility of executive salaries at $1 million"[41]. The result? Murky compensation packages laden with stock options and 'golden parachute' schemes, which predicated ill-

40 Alan Greenspan, as quoted in "Just Like the Rest of US", Pink, Daniel H., Fast Company.com, http://www.fastcompany.com/online/63/rightnow.html, page 1.
41 Pink, Daniel H., "Just Like the Rest of US", Fast Company.com, http://www.fastcompany.com/online/63/rightnow.html, page 2.

devised accounting reports designed to improve public financial statements - despite mounting losses. In the first three quarters of 2001, "Nasdaq 100 companies disclosed combined losses of over $82 billion to the SEC while reporting, thanks to a variety of pro-forma adjustments, profits of $19 billion to shareholders."[42] Such numbers startle and astound, yet are consistent with the mentality that the late 90's engendered of achieving ever-increasing stock prices at any costs. As looking back it seems that no one was to be trusted, hence CG is now in vogue. Yet how could it not have been so beforehand?

"At Calma Coop, we believe our results need to be as clear and as objective as possible – by explaining how we calculate them ex ante. We believe adherence to GAAP to be the most accurate measure of a company's true performance. In the event of differences between financial accounting and tax reports, we will seek to reconcile them in the most forthright manner possible. We do not intend to hide the organization's financial health from any of our stakeholders – not from our employees or colleagues, nor our investors or customers, nor the government or regulators, nor from ourselves or anyone who wants to evaluate our financial performance in the past, the present or with our best-guess predictions for the future."

The pressure upon a publicly held company to maximize shareholders' interests and constantly increase share price belies basic tenets of economics. We do not believe it is possible to always maximize stakeholder wealth and company profits simultaneously, and it is precisely such thinking that led to distorted reporting. We do believe that the system of capital markets with its external monitors to be tried and true, and that it is effective in terms of "credibility, independence, harshness, and speed of evaluation".[43] We believe the onus of CG lies in monitoring the internal controls of reporting in creating wealth for all relevant parties.

To that end, the selection of a CEO and the members of a BoD are critical to achieving success. Yet we do not think that any one person, or group of directors, is necessarily best equipped to determine the optimal plan of action for all involved. And there are some striking examples to demonstrate how a team attitude can work best. Consider Orpheus, a chamber orchestra that performs without a conductor[44]. As an award winning group, they have achieved continued growing success for 30 years – and they work by committee and collaborative core groups in order to select pieces, develop the interpretation of a musical work, structure rehearsals, and evaluate progress. All this done without an authoritarian conductor waving a stick at them. Imagine if there was a public company that did not have to jump through hurdles at the waving of the 'stick'– i.e. the quarterly report? We believe such a vision for corporations to be tenable and valid.

IT IS IMPORTANT FOR THE CEO TO DEMONSTRATE HUMILITY IN THE FACE OF EXCELLENCE, AND PERSEVERANCE IN TIMES OF DIFFICULTY. MAINTAINING AN EVEN KEEL THROUGH ALL ECONOMIC AND PROFESSIONAL SITUATIONS INSPIRES FAITH AND CONFIDENCE

A further example of total teamwork is the Mayo Clinic in Rochester, Minnesota[45]. Widely recognized as one of the best medical facilities on the planet, it practices medicine by consensus. 'Colleagues' or doctors meet daily to discuss, in concert, the diagnosis and treatment of individual cases. By joining together to exchange opinions and expertise, their patients' results are achieved quicker and with greater success rates than traditional methods in standardized institutions elsewhere. And all this without losing sight of the bottom line: "The best interest of the patient is the only interest to be considered."[46]

ECHOING THE 'SIX-DEGREES OF SEPARATION' THEORY – THAT ANY TWO PEOPLE IN THE US ARE CONNECTED BY A CHAIN OF SIX OR FEWER FRIENDS OR ACQUAINTANCES - A RECENT STUDY FOUND ON AVERAGE THAT ANY TWO OF THE 546 LARGEST US CORPORATE BOARDS ARE CONNECTED BY ONLY 3.5 DEGREES

"At Calma Coop, we believe in serving the best interests of our stakeholders. We will not sacrifice team morale in pursuit of profit growth only. We will not compromise core values to meet end-of-quarter results. We will not forsake the exchange of ideas and expertise for the will of a minority. We believe in longevity of performance as achieved by careful attention to the integrity and conviction of our beliefs."

So, if teamwork is key, how does the CEO fit in? We believe the best interests of stakeholders are realized when the CEO is a product of the company itself. We do not believe in sourcing outside help, but rather we favour promotion from within. Another common problem has been the compensations received by CEOs, which can skyrocket as a result of company results – results which are certainly questionable at best. The average compensation of the "top ten CEOs went from $3.5 million in 1981 to $154 million in 2000; a 44 times increase overall, with an average growth rate of about 21 percent"[47]. The tendency towards such packages is ludicrous. Instead, we propose that CEOs' benefits be associated with tangible results and in a manner that establishes a foundation for long-term growth and productivity. We propose that CEOs' salaries be tied to set percentage increases in sales and productivity growth, ratings by employees and investors, ability to deliver upon stated objectives and goals, and independent analysis of ethical conduct. We believe that such salaries should be paid only if CEOs can conduct structured appointments for discussion with employees from all levels on a frequent basis, and also only if they attend training in Executive Management (beyond their core expertise) with added focus upon Corporate Social Responsibility pertaining to all stakeholders' expectations. Finally, we think stock options are the Adam's apple of a CEO's garden. Instead, we suggest quarterly allotments of 'deferred stock units' assigned on a performance basis that are not converted to "the shares' equivalent in cash until a year after they [the CEO] leave"[48].

We believe in cultivating a vision of rational expectation. In a recent conference call, eBay chief Meg Whitman declared that eBay "is poised to be one of those great companies that come along only rarely in a generation." as she gloated about "performance nothing short of phenomenal"[49]. Such posturing is detrimental to the longevity of a firm. While we do not discourage accelerated growth, we do not expect it to occur indefinitely. Ergo, we think it is important for the CEO to demonstrate humility in the face of excellence, and perseverance in times of

42 Lazzari, Valter, "Myths of Shareholder Value and Efficiency" European Business Forum, http://eee.ebfonline.com/at_forum.asp?id=318&linked=317, page 2.
43 ibid, page 2.
44 Ron Lieber, "Leadership Ensemble", an article on Fast Company.com, http://www.fastcompany.com/online/34/orpheus.html.
45 Paul Roberts, "The Agenda – Total Teamwork", an article on Fast Company.com, http://www.fastcompany.com/online/23/totteam.html.
46 Paul Roberts, "The Agenda – Total Teamwork", an article on Fast Company.com, http://www.fastcompany.com/online/23/totteam.html, page 4.
47 Lazzari, Valter, "Myths of Shareholder Value and Efficiency" European Business Forum, link: http://eee.ebfonline.com/at_forum.asp?id=318&linked=317.
48 Lublin, Joann S., "More Work, More Pay", Wall Street Journal Europe, February 23, 2003, page R5.
49 Simons, David "Ebay's Megalomania", Forbes.com, March 13, 2003, http://www.forbes.com/2003/03/13/cx_ds_0313simons.html, page 1.

difficulty. Maintaining an even keel through all economic and professional situations inspires faith and confidence.

"At Calma Coop, we believe the spirit of leadership must rest upon a solid base of trust from the entire organization. We believe the CEO needs the support of all, and that the Board of Directors should be the shining example of how a company addresses the needs and concerns of all, in a manner that exemplifies the organization's values. Training and ongoing learning shall be conducted at all levels, and all involved shall have a voice in the company's direction. We believe in consistency before short-term highlights, and that the management of a business is to be run like a marathon, and not like a sprint."

Further to the epidemic of CEO scandal has been the malfunctioning of BoDs. This has developed by a lack of attention to design, and is one that is easily correctable. In Europe, where shareholders are more concentrated, BoDs have typically represented the Old Boys' networks of their respective countries[50]. In the US, the issue has been the 'who do you know?' mentality and the preponderance of Directors to sit upon several boards, often despite glaring conflicts of interest in those Boards served. "Echoing the 'six-degrees of separation' theory – that any two people in the US are connected by a chain of six or fewer friends or acquaintances - a recent study found on average that any two of the 546 largest US corporate boards are connected by only 3.5 degrees."[51] This cycle of backslapping and exclusion must be arrested. Furthermore, there is little formal training or specific accreditation required to hold such positions. Posts are awarded based upon referral or the recommendations of executive search. And finally, such BoDs rarely comprise employees. We think there are serious flaws in such structures, and believe a BoD can be best designed with three key stakeholders only: employees, investors and independent advisors.

To begin, BoDs need to modify investors' expectations. If CEOs and BoDs are to be cultivated for better performance over the long-term, investors need to recognize that profits are not going to continue to skyrocket in the short-term. We encourage investor membership upon the BoD, but in a limited form. Our design for an effective BoD will include a rotating group of employees, changing quarterly and charged with representing, by voting and consensual decision, the majority interests of all employees. We propose that another third of the BoD be comprised of the largest shareholders of outstanding company stock. And we feel a third contingent should be independent directors selected by the BoD itself, and measured upon industry experience, ability to commit substantial time, and with a clear understanding of their role in developing the organization's responsibility to all stakeholders.

With the Sarbanes-Oxley act of 2002, the SEC has established a Public Company Accounting (PCA) Oversight Board[52]. We believe that at least one member of the BoD should be independent and well versed in the PCA Oversight Board's mandate and regulatory practices. In fact, we encourage the establishment of an SEC license for Board Directors whereby they are officially appointed and registered, with salaries paid by the SEC, terms limited to a maximum of seven years, and no directors to hold seats on more than three boards[53]. At least one Director on the Board should be qualified with these credentials. For effectiveness' sake to deliver objective evaluations and assess performance, we propose that the BoD periodically hold meetings without the CEO present. We believe that Directors should devote more than part-time efforts to their posts, i.e. more than the industry average of 200 hours per annum[54], with an initial commitment of 300 hours a year. Overriding these policies, we believe the cardinal criterion to be Directors' personalities. Too often, BoDs are victim of Groupthink and dissension is not encouraged[55]. We believe that there should be an active designation of the role of devil's advocate, to provide counterpoints and antithetical perspectives. And lastly, we believe that Directors should also undergo formal training. There are many programs currently available for such learning, indeed modified EMBA and business classes are being offered on an increasing part-time basis. We feel this to be an integral component for maintaining currency of expertise and robustness of perspective. And in many countries such as Canada, a fixed percentage of company revenue is legally mandated for employee training purposes, creating the ideal budget for such academic pursuit.

"At Calma Coop, we promote equality of opinion and contribution. From the shop floor to administrative services to executive management to the Board of Directors, all are expected to advance the stakeholders' interests. For transparency's sake, we propose a new concept of glass floors and glass ceilings: from any vantage point in the organization's hierarchy, stakeholders can witness the performance of all others. We propose a working concept based upon full disclosure of responsibilities, performance objectives, ethical evaluations and 360° feedback. At the top executive levels, we believe the CEO to be the linchpin for achieving the best interests of all stakeholders. And our concept of the Holy Trinity, a BoD comprised of three groups: employees, investors and independent directors, shall be mandated to function as an irreproachable source of guidance and corporate responsibility."

50 Mijuk, Goran, "Money Talks....A Little", Wall Street Journal Europe, February 23, 2003, page R3.
51 Plitch, Phyllis "Ready and Able", Wall Street Journal Europe, February 23, 2003, page R2.
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Corporate Governance: Are we trying to Control the Uncontrollable?

One of the continuing themes of human existence is the tension between individual freedom and institutional power. As worldwide communications, financial markets and industrial enterprises expand; the traditional concepts by which corporate power was to be held accountable simply do not work. Neither law nor practice has developed an acceptable system of accountability. The consequences are too important to ignore. There is no longer an effective control over company operations. The corporate functioning across countries and continents means control by a single sovereign is no longer possible. We have moved from a world where corporation and state coexisted within a single political entity into a world where business enterprises are global and political authority is still limited by political boundaries. Corporate power across the globe has never been more prevalent.

Growing up, my mother used to say 'treat those the way you expect to be treated', something I took on with great momentum; however, like most lessons learnt I soon realized that despite giving people respect, integrity and lucidity; there were many of whom did not return this attitude. Finding new ways to gain this reverence was (and is) a difficult feat. This attitude is a theme that runs strong throughout Corporate Governance. How can shareholders treat and reward CEO's while still gain the respect and trust required in controlling their long-term investment?

This balance of deference and trust is the question that many have asked and perhaps one where there is no answer. There are many resolutions that attempt to improve this relationship and minimize the potential for disrespect, dishonesty and failure. This report looks at Corporate Governance, its importance in the global community, CEO compensation and the role of the Board of Directors.

Part I – Corporate Governance

Corporate governance has succeeded in attracting a good deal of public interest and as trade barriers fall, markets expand and restrictions on investment disappear it has become gradually easier for investors to invest internationally. As the capital market becomes worldwide corporate governance in individual countries has begun to play an important part. With intense competition and global financial 'ethics' investors are looking for investment structures that will serve their interests more.

The paradigm itself is scantily defined due to its complexity and potential to cover a large number of distinct pecuniary occurrences. There are many different definitions reflecting Corporate governance ranging from 'a system by which business corporations are directed and controlled with a structure that specifies the distribution of rights and responsibilities among different participants in the corporation[56]' to "the relationship of a company to its shareholders or, more broadly, as its relationship to society"[57]. Most definitions all come to a similar conclusion that Corporate Governance is the distribution of rights and responsibilities among different participants in the corporation.

The Global Investor Opinion Survey[58] 2002 shows an overwhelming majority of investors are prepared to pay a premium for companies with high governance standards. Many countries have influenced governmental reforms where investors are unified in expensing stock options in P&L statements, market regulation and choosing an infrastructure with a downward pressure on corruption (see graph 1).
An effective system requires a method of assessments and balances, ensuring that the right questions get asked[59] of the right people, limit conflicts of interest, sound decisions making and implementation.

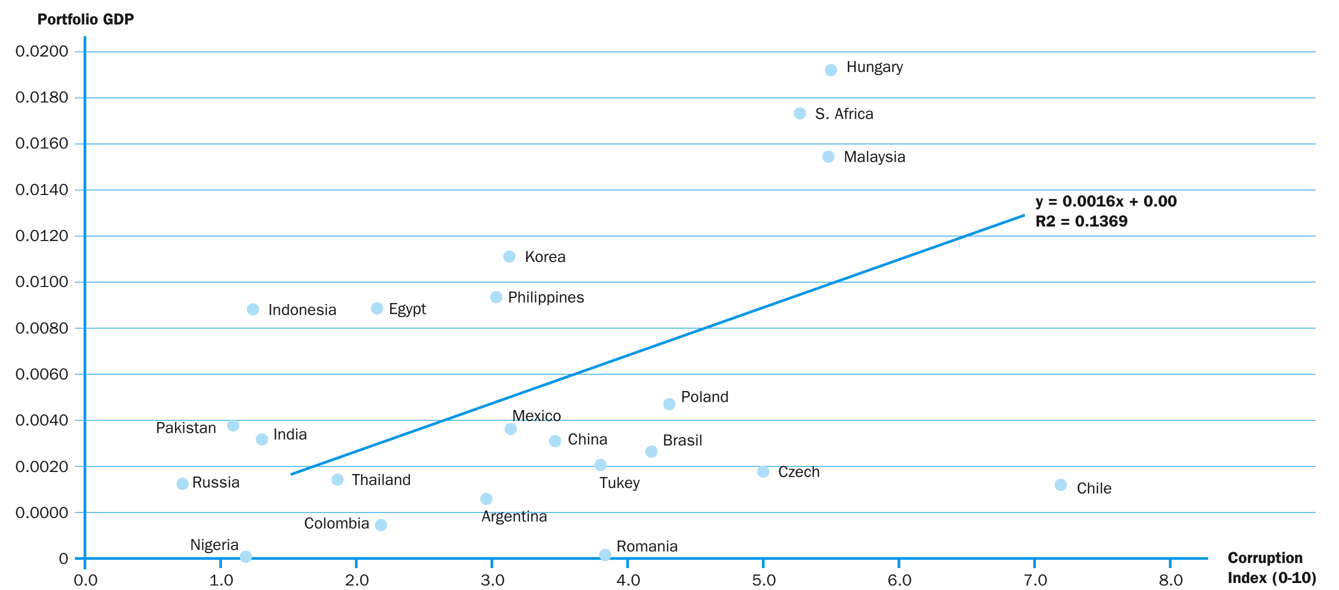
Corporate governance evaluates alternatives by measuring them against the goals of individual freedom, maximizing wealth, and managing change. Perhaps the most difficult task in is achieving the optimal balance between power and accountability. All persons in the corporation need power to perform their tasks, but accountability is needed to ensure that those tasks are performed for the benefit of the owners, long term. A system needs to be designed to permit the appropriate scope of authority (power) and limit its abuse (accountability).

HOW CAN SHAREHOLDERS TREAT AND REWARD CEOs WHILE STILL GAIN THE RESPECT AND TRUST REQUIRED IN CONTROLLING THEIR LONG-TERM INVESTMENT? THIS BALANCE OF DEFERENCE AND TRUST IS THE QUESTION THAT MANY HAVE ASKED AND PERHAPS ONE WHERE THERE IS NO ANSWER

Owner and manager will always have different interests, and at some point those interests will conflict. Harvard Professor Michael Porter wrote a paper on competitiveness analyzing capital allocation stating *"These long-term owners would commit to maintaining ownership for an extended period, and to becoming fully informed about the company. In return for a long-term ownership commitment, however, must come a restructuring of the role of owners in governance. Long-term owners must have insider status, full access to information, influence with management, and seats on the board."*

Companies around the world are feeling forced by competitive pressures into offering pay schemes similar to those of US companies; whose structures have been dictated by factors other than shareholder value creation, such as accounting rules, tax and lack of shareowner

Graph 1
Corruption and Portfolio Equity Flows in Developin Countries (1999)



Source: McKinsey Global Investor Opinion Survey on Corporate Governance 2002

56 Financial Times [1997].
57 McKinsey Global Investor Opinion Survey on Corporate Governance 2002.
58 McKinsey Global Investor Opinion Survey on Corporate Governance 2002.
59 "Do we need to revise our corporate strategy? Our organizational structure? Our allocation of resources? How is the CEO doing? How is the board doing?"

supervision. There is excessive use of stock options, inefficient performance of board to monitor compensation, short-term management, lack of balance in relationships; which have lead to gains from options unrelated to management operating performance.

Part II – Principles & Standards

The first challenge for companies is to design a successful set of principles and standards, preferably one to be applied across all corporations in legal, economic, ownership and social systems in both developed and developing countries[60]. Currently, there is no formal set of standards that any corporation is obliged to use. Many investors support these ideas but differ on which one should prevail. Evidence shows that the most favorable standards to be chosen as a global standard are that of Western Europe. Many companies use the OECD[61] Principles of Corporate Governance as a benchmark for assessments[62]. Who have looked to strengthen corporate governance practices world-wide in the wake of a series of business scandals undermining public trust in companies and stock markets. The challenge facing policymakers is to strike a balance between government control of markets and corporations and increased monitoring by market participants. The dispute is whether the free enterprise system can devise a method of performance that will be competitive and not perceived as unfair to individual citizens. This debate weighs heavily in Germany: Jurgen Schrempp[63]: *"Shareholder value must not be pushed for short-term success at the expense of future viability and future earnings potential."* Critics could argue that this redefinition of shareholder value might allow unprofitable strategies to foster concealed under long-termism.

PERHAPS THE MOST DIFFICULT TASK IN IS ACHIEVING THE OPTIMAL BALANCE BETWEEN POWER AND ACCOUNTABILITY. ALL PERSONS IN THE CORPORATION NEED POWER TO PERFORM THEIR TASKS, BUT ACCOUNTABILITY IS NEEDED TO ENSURE THAT THOSE TASKS ARE PERFORMED FOR THE BENEFIT OF THE OWNERS, LONG TERM

Part III – Board of Directors

Shareholder trust is well-placed in the care of a company's directors and managers; without it results can be disastrous. Shareholders necessitate control over all actions that could affect their investments, including the opportunity to approve or disapprove pay schemes and the freedom to elect directors. While shareholders cannot legally select the managers of a company, they can elect the directors. Since directors oversee management, it is important that shareholders have the ability to freely and intelligently exercise this vote.

Traditionally, companies' directors have been given the role of choosing and monitoring its managers; recent thoughts claim directors should go beyond this and foster effective policies and act in a strategic capacity. They require a recognized role in governing the corporation. Boards need to be more independent and receive greater effectiveness through better director selection, more discipline and greater time commitment, accounting standards, board independence and tighter regulations.

Boards are protected against liability by relying in good faith on reports of experts and officers; an absence of this faith can eliminate protection. Establishing this faith may require a careful evaluation of the adequacy of information systems, an assessment of the biases of the "reporter" and a thorough probing of the assertions, conclusions, and recommendations of management and advisers. The mere prospect of this rigorous vetting should typically make management to do a better job initially. Since 2002, many boards have been obsessing over the regulator function often at the expense of attending to these other tasks. Being a board member is requiring a greater time commitment than ever before.

A BOARD THAT ORGANIZES ITS EFFORTS WELL (THROUGH COMMITTEES) AND ALLOWS ITS MEMBERS TO DISCHARGE THEIR DUTIES THOROUGHLY AND EFFICIENTLY, WILL DO BETTER IN RETAINING VALUED MEMBERS AND WILL GAIN A COMPETITIVE ADVANTAGE IN RECRUITING NEW MEMBERS; IN SETTING ITS OWN CALENDAR IS DEMONSTRATING ITS INDEPENDENCE

A board that organizes its efforts well (through committees) and allows its members to discharge their duties thoroughly and efficiently, will do better in retaining valued members and will gain a competitive advantage in recruiting new members; in setting its own calendar is demonstrating its independence. After establishing that there is an ownership to whom management will be accountable, the 'language of accountability' then needs to be clear, clearly understood by both sides and understandable to the public.

Business enterprises are supposed to take risks and the law recognizes this fact. The securities market recognizes this through equity pricing models. It would be harmful in the long run if the current environment were to cause corporate boards to withdraw from the prudent risk which is required for innovation. On the other hand, especially in the current environment, taking risk on disclosure positions or accounting treatments is not practical. There is a cost to transparency, which may be mitigated by skilful press relations. But conversely the potential cost of inappropriate non-disclosure is more sizeable than the cost of transparency. Thomas Cole[64] paraphrase Leroy Paige's (legendry pitcher from US) rules: Work like you don't need the money; love like you've never been hurt; Dance like no one is watching to don't serve just for the money; be diligent like you've already been burned, govern like everyone is watching!

Part IV - CEO Compensation

"'Good' corporate governance simply means that structures and processes are in place to ensure that directors have the ability to objectively and effectively assess management and corporate performance."[65] The average chief executive officer of an American corporation now makes 531 times as much in pay, bonuses and stock options as the average factory worker[66].
The pay of CEO is the most visible manifestation of conflict of interest between agents and principles e.g. Enron declared bankruptcy, 6,100

60 In the US and international marketplace, the California Public Employees' Retirement System (CalPERS) is recognized as a standard-bearer for the movement.
61 Organisation for Economic Cooperation and Development.
62 These provide an international benchmark for best practice in corporate governance and have become a global reference for shaping public policy through regional roundtables organised by the OECD and the World Bank in emerging and transition economies. They are used as one of the criteria in country assessments by the World Bank.
63 Chairman of DaimlerChrysler.
63 Chairman of DaimlerChrysler.
64 Principles Based Behaviour for Boards, Directors & Boards Journal, Fall 2002.
65 Robert A. G. Monks.
66 According to the report by the liberal-leaning Institute for Policy Studies and United for a Fair Economy, a Boston organization focusing on economic inequality.

out of work and 401(k) participants lose millions but CEO Ken Lay exercised $123 million in stock options prior to the scandal. Some CEO's with the biggest pay raises are also the ones laying off the most workers, including Disney CEO Michael Eisner, who earned $72.8 million in 2000 while laying off 4,000 workers[67]. Shareholders have been offering incredible packages to CEO's in the hope that in return they will get transparency, sincerity and direct and open communication between themselves and their investment. Good Executives deserve to get paid well because they are capable of creating enormous value for the companies and shareholders who employ them. But currently there is an increasing separation between the pay and the shareholder value created.
One study[68] shows no correlation between a company's performance and the amount of stock or options owned by its corporate executives. Instead, dozens of companies underperformed the competition.

Many believe executives are better motivated if they have a stake in their company's stock performance. However, options should be indexed so a CEO is not rewarded for a general rise in the market, nor punished for a general market sell-off. The employment contract can give us some sense of the board's ability - and willingness - to impose meaningful standards.

Even where remuneration is mediated through a committee of independent non-executive directors there is real scope for conflicts of interest. That is why shareholders have increasingly used equity-based incentives, in the hope of ensuring a large bulk of executives' remuneration is in the form of company stock to encourage agents to act deliberately and clearly in the long-term interests of shareholders rather than their own. Performance based compensation should correspond to the corporations long-term goals with clear correlations between costs and benefits.

Remuneration of corporate directors or supervisory board members and key executives should be aligned with the interests of shareowners. Corporations should disclose in each annual report or proxy statement the board's policies on remuneration-and, preferably, the remuneration break up of individual directors and top executives-so that it can be judged whether corporate pay policies and practices meet that standard.

Executive Remuneration is controlled by a risk/reward performance evaluation. From the executive's perspective, the client expects to be rewarded for previously demonstrated work experience in the form of short and long term incentive compensation. The level of risk each client is willing to take is situation specific. Greater reward is supposed

WORK LIKE YOU DON'T NEED THE MONEY; LOVE LIKE YOU'VE NEVER BEEN HURT; DANCE LIKE NO ONE IS WATCHING TO DON'T SERVE JUST FOR THE MONEY; BE DILIGENT LIKE YOU'VE ALREADY BEEN BURNED, GOVERN LIKE EVERYONE IS WATCHING!

to compensate for greater risk, but many CEO's seem to have figured out how to turn this to their personal benefit. For instance, Kmart went bankrupt and laid off 22,000 with no severance while the CEO received at least $9.5 million in severance[69].

In general, pay surveys[70] reveal that continental Europe pays its executives far more in the way of salary and bonus than do either the US or the UK - often because more complex forms of payment have not been possible nor part of corporate culture.

In contrast, in the US and UK, there is more of an emphasis on equity-linked incentive pay. While the levels of salary and bonus are pretty much comparable in these two countries, US incentives are far in excess of anything seen in the UK. The largest and most international companies in all these countries are beginning to move towards pay structures closer and closer to the US model.

LARGE CORPORATIONS ARE COMPLEX SYSTEMS, THE SCOPE OF WHOSE FUNCTION IS SUSCEPTIBLE TO HUMAN INFLUENCE RELYING ON PEOPLE AND PEOPLE WILL ALWAYS HAVE INDIVIDUALITY, EMOTIONS AND A FIGURE OR 'BUYING' PRICE

Equity-linked remuneration can create opportunistic behavior where managers pursue personal interests to the detriment of shareholders. Most structures seem to reward executives regardless; there is no win-only remuneration where bonus reflects business success removing personal loss for executive. Stiff performance conditions (directly linked to aims and strategy of the business), should become standard.

The move away from 'options' is currently difficult in some countries due to accounting and tax rules. Nevertheless, there are signs that option schemes are not efficient at linking executive pay to shareholder value. While the technology boom was an extreme case, it demonstrates the problems well. The tremendous sums of money made by many managers through exercising options had little to do with their own qualities as managers: their sector as a whole was in favour and their performance as managers was irrelevant. Thus, the managers benefited from the upside of the extreme valuations - which had little to do with their personal performance - and yet are protected from the downside of the share price collapses. Relative performance measurements against the rest of the sector would provide better measures of the actual performance of those managers.

Part V – Conclusion

Corporate governance is still an important tool for monitoring performance and enhancing value. Large corporations are complex systems, the scope of whose function is susceptible to human influence relying on people and people will always have individuality, emotions and a figure or 'buying' price. Key performance measures incorporating both financial and non-financial measures are vital. Shareholders need to find new innovative ways in controlling perhaps the uncontrollable.

Over the next few years corporate governance needs to measure the performance of companies not simply by looking at earnings and share prices, but by the corporations long term positioning. As The Business Roundtable[71] stated: "Boards have a responsibility to ensure that compensation plans are appropriate and competitive and properly reflect the objectives and performance of management and the corporation. Incentive plans will vary from corporation to corporation and should be designed to provide the proper balance between long- and short-term performance incentives." Ultimately the solution to corporate governance is to get a balance of control between the agent and principle avoiding asymmetry of information and disharmony of interests.

67 http://www.aflcio.org/corporateamerica/paywatch/pay/index.cfm.
68 published in the Academy of Management Journal.
69 http://www.aflcio.org/corporateamerica/paywatch/pay/index.cfm.
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CEO Compensation & BoD Appointment & Remuneration

"...those in a position of trust, with the power to enrich themselves at the expense of others, are usually trustworthy enough not to do so....especially when they are under the close scrutiny of a growling bulldog at all times."

Elliot Spitzer, *New York State Attorney General*

Introduction

Given the recent events in corporate America and the world, the general feeling is that corporate governance is an issue that requires airtight solutions. However, the perfect solution may never be found to the problems that plague corporate entities today. Control of managers, transparency of directors elections, board composition and skill-sets necessary to be a board member have all been issues that have been contemplated in the Sarbanes-Oxley, the new NYSE rules for listing and the different reports coming up in the U.K. and Germany.

However, none of these new rules has seriously addressed two fundamental topics. First, CEO compensation has been excessively high in recent years, raising eyebrows among employees and shareholders alike. Rewards have been constructed in a way which encourages management to show steep earnings growth, which in turn cultivates undue risk taking and even fraud. At the root, this is a problem in itself, as it tends to distort the long term view that a CEO should have in favour of a shorter term, more volatile view.

The incentive of the CEO is therefore to undermine certain aspects of corporate governance by trying to have a friendly board that supports him in his endeavours. Secondly, a problem not addressed by regulations is how to make boards more prone to discussion and constructive dissent, boards that, by nature, oppose the views of the CEO while still trying to be constructive. In this analysis, we have thought of ways to clearly address these two points in a concise and direct manner, by proposing ideas that could and should voluntarily be adopted by corporations.

I When it comes to CEO or management compensation, everybody agrees that it is necessary to have their interests aligned with those of the corporation. A system by which an escrow account is created to help distribute CEO's bonuses over their tenure could help maintain the right incentives in place, and make the CEO retain a long term view rather than a short term pursuit of ever-increasing bonuses.

II The second problem to address is how to make boards less CEO-friendly and more shareholder-friendly, boards oriented towards constructive dissent and productive ideas. A possible solution would be to incorporate a director that represents the debt holders of the company, who would have different views on, for example, risk taking, but nonetheless wants to preserve the financial and structural well-being of the corporation, which is also in his or her best interest.

A SYSTEM BY WHICH AN ESCROW ACCOUNT IS CREATED TO HELP DISTRIBUTE CEO'S BONUSES OVER THEIR TENURE COULD HELP MAINTAIN THE RIGHT INCENTIVES IN PLACE, AND MAKE THE CEO RETAIN A LONG TERM VIEW RATHER THAN A SHORT TERM PURSUIT OF EVER-INCREASING BONUSES

The CEO compensation problem: Background

During the last decade, CEO's compensation increased over 182%, after adjusting for inflation[72]. This happened in a decade where the average blue collar worker's income, which constitutes approximately 80 percent of the workforce, actually declined. This seems hardly fair. The voices of reason are heard but their recommendations get implemented about as well as one can expect when the proverbial fox is left in charge of the hen house. In an era of cost-cutting, downsizing, and performance-based compensation, CEO's still get a free ride, walking away with an increasing and, in nearly every case, undeserved slice of the corporate profits pie. Even more importantly, the mix of executive pay is now heavily weighted toward other forms of compensation, particularly lucrative options packages. Chief executives at the largest 1,000 American companies made $1.2 billion last year from the exercise of options but still held options worth about $9.9 billion[73].

While options are one way to inspire executive loyalty and reward long-term performance, they amount to deferred compensation since they generally vest over a five- to seven-year period. No institution tracks such deferrals, but they are believed to total tens of billions of dollars[74].

72 CEO Compensation: A Problem That Just Gets Worse--Louis Corrigan.
73 Graef Crystal.
74 New York Times.

Theoretically, stock options are intended to reduce the inevitable principal-agent cost. Managers – the agents – will always have some different interests than the common shareholders – the principals – and thus sometimes act differently then shareholders would want them to. But if sufficient portion of managers' net worth is tied in stocks of their firm, this principal-agent cost should be reduced. However, options are more valuable the more volatile the stock is (Black–Scholes and Merton option pricing theory). When a company takes on risky projects it becomes more risky, thereby increasing the volatility of share price and the value of corresponding stock options. However, this may be in direct conflict with shareholders interests who, other things being equal, prefer stable cash flows. Stock options that were intended to bring managers and common shareholder on the same boat thus actually can have the opposite effect. Indeed, the surge in option plans in the 1990's may have been a significant factor in current wave of corporate scandals and bankruptcies.

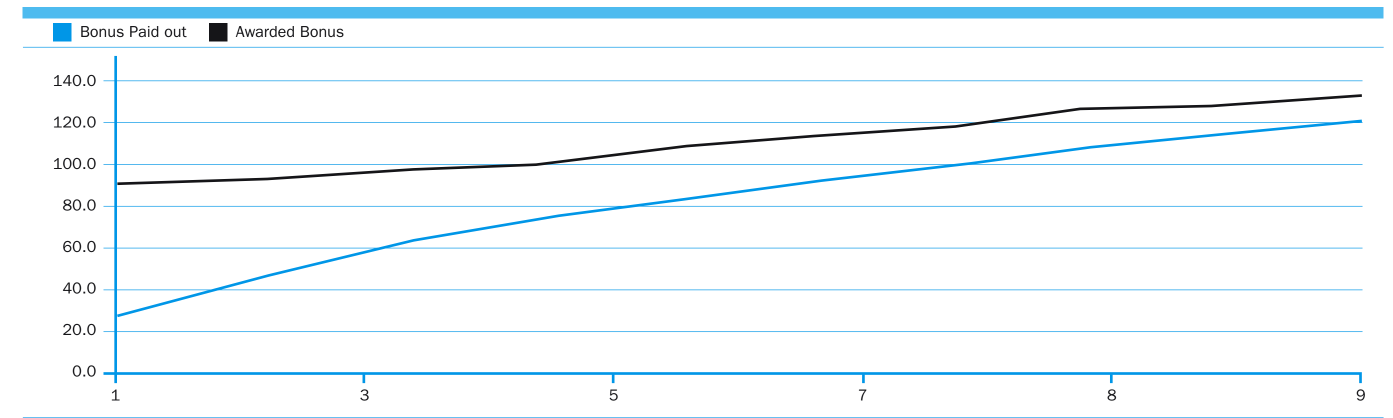
Putting in the right incentives

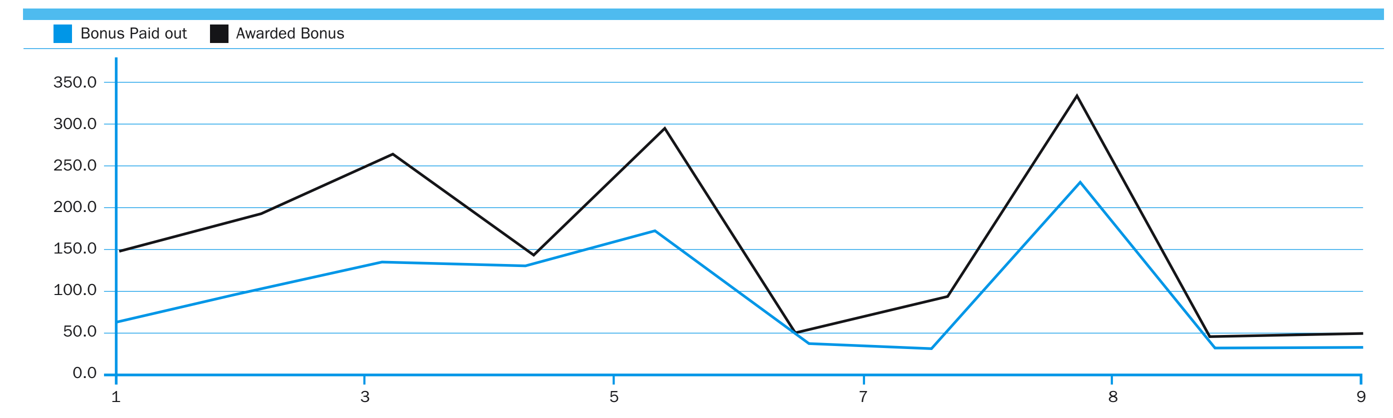
Given how events have unravelled, a new system must be put in place to give CEO's and managers the right incentives, fostering a long term view for the company. In order to compensate for long run success, but not the occasional super-year, bonuses should be paid out in steps over many years and only if results are permanent. To give a clearer picture of what we envision, an example is provided. When the bonus for a certain year is decided, cash is awarded in addition to some bonus in the form of stock, which is generally preferable to stock options. However, only about one third of the cash and stock will be delivered, and the remainder put into an escrow account. The following year, the same steps are taken, but in addition to getting the third of the new bonus delivered, the manager also gets a percentage of the balance in the escrow account (say, 20-25%).

The two graphs on the following page display how this could play out in two different scenarios. The first graph shows bonus payments to a CEO of a firm that has earnings growth of 3% per year for ten years. The "Awarded Bonus" line represents awarded bonus as a fixed percentage of net income, and the paid out bonus, if no escrow account exists. The "Bonus Paid Out" line shows how the bonus paid out rapidly approaches the awarded bonus, with the remainder stored in escrow for future payments. In the second graph, the same two compensations schemes are displayed for a firm with volatile earnings. In this case, the CEO will never get paid the entire bonus he has earned, as some of it was stored in escrow and the board and compensation committee will freeze that part and presumably fire or reprimand the CEO.

In this example, the firm with stable growth has higher cumulative net income over the ten year period. Awarded bonus is higher in the scenario displayed in the graph with volatile earnings, but bonus paid-out is higher in the stable growth scenario. (see Appendix for assumptions).

This kind of system has several implications. First, if the firm performs consistently, the manager will get delivered similar amounts as if there was no escrow account, since he or she will be given the benefit of part of the account balance as well as getting a portion of last years bonuses. Secondly, if earnings are volatile, the manager will only have received a portion of the awarded bonus from a super-year, and bonus in the escrow account can be withdrawn again if results are very poor. Thirdly, managers will know of a pile of money stacked away in the escrow account and will not want to jeopardize losing that by making bad investment decisions. Finally, managers will be reluctant to join a rival





or quit without consent, as they may be foregoing whatever is withheld in the escrow account.

This system will probably not put a complete stop to abuse and misdeeds, but it will try to reward the CEO on a more rational basis, and on longer term performance and track record.

OPTIONS ARE MORE VALUABLE THE MORE VOLATILE THE STOCK IS. WHEN A COMPANY TAKES ON RISKY PROJECTS IT BECOMES MORE RISKY, THEREBY INCREASING THE VOLATILITY OF SHARE PRICE AND THE VALUE OF CORRESPONDING STOCK OPTIONS

The board of directors dilemma: Background

Problems of corporate governance are not limited to CEO or management compensation. Boards of directors also share the blame for not invoking their right and obligation of controlling the performance of managers. Board members have been altogether too friendly with management and have exercised little control over them. As an example a survey by the NY Times has shown that in 420 out of 2000 American companies, the member of the compensation committee included relatives or people with ties to the company or the CEO.

The problem does not end there. The election of the board members is not transparent to the shareholder, nor is the aptitude of those who are elected. Use of proxy votes by major shareholders and institutional

STOCK OPTIONS THAT WERE INTENDED TO BRING MANAGERS AND COMMON SHAREHOLDER ON THE SAME BOAT THUS ACTUALLY CAN HAVE THE OPPOSITE EFFECT

investors clouds the air even more. Compensation to directors is also in the eye of the storm. Directors at bankrupt insurer Conseco were provided with soft loans to purchase stock of the company, money which they never returned. These kinds of practices go against the very nature of the function of the board. Although directors should be there to control and reduce the agency problem, and following Michael Jensen's[75] definition of agency costs, boards are not doing a good job at this either.

To address these issues, recent proposals and recommendations have been flowing. The New York Stock Exchange's new proposals for boardroom standards at listed companies aim to expand the responsibility and authority of directors. The proposals propel the role and authority of independent directors, tighten regulations of the audit committee and require that a majority of a company's board consist of independent directors, meeting regularly on their own without the CEO. In addition, investors must approve all equity-based pay plans. These regulations affect not only US companies, but any company that wants to tap the US capital markets. This is a broad step that will help make boards and CEO's more aware of their duty towards the real owners of corporations: shareholders.

75 Michael Jensen: "The agency costs of free cash flows".

In addition to the NYSE rules, the Sarbanes-Oxley Act of 2002 requires a new level of accountability around reporting a company's financial performance. The Act requires that CEO's and CFO's of publicly held companies certify the accuracy of financial statements and financial information issued by their companies and certify that "internal controls and procedures for financial reporting" have been designed and are in place.

The Sarbanes-Oxley Act and the other initiatives have begun to address the issue of election of board members. The disclosure by mutual funds exercising proxy votes is an important step in the right direction, towards making the election process more transparent. Added to this, we believe that directors to be elected or re-elected should provide information about themselves, by making available their resumes, their track records and the relevant skills they have for the job. Incorporating more independent directors, as the NYSE is ruling, is also a step in the right direction and one that will lead to better performing boards.
Other interesting ideas are being tossed around. Professor Marti Subramanyan of NYU Stern, suggests that board members evaluate each other on a scorecard. The scorecard will give weight to matters currently under scrutiny, such as attendance, whether members understand major issues at stake, are financially literate and so forth. The board member with the lowest score will automatically quit at next annual meeting. Ideas of this sort are intriguing and worth exploring.

Additionally, there are some issues concerning the compensation of directors which we believe are being addressed. As a starting point, base salaries of directors could be increased from the current industry average of about $50,000[76] in order to be able to attract talent. Added to this, directors should be compensated on a bonus plus stock basis, in a similar fashion as a CEO, using the kind of scheme that was outlined in this paper. Recent articles in the Financial Times, and comments by head-hunter firms such as Korn/Ferry, suggest that pay for directors will increase dramatically, in light of the need to have competent and talented people sitting in boards.

Making boards more effective: Taking it one step further

The board is in an advisory position to the CEO and the company. It discusses the strategy and operations of the company and brainstorms different ideas about the direction the company is headed. However, unless there is a certain amount of healthy conflict, boards tend to fall in line behind the CEO and fail in their duty of objectively advising the CEO. In a recent paper in the Harvard Business Review[77], the author clearly outlines how boards tend to foster too little discrepancy and opposing views, where team playing is viewed as a desired quality. This reduces the possibility of enforcing a "checks and balances" process between the CEO and the board. Thus, a more contentious atmosphere is recommendable, and this atmosphere must be inherent to boards.

This could be achieved by bringing into the board a representative of debt holders. Many ideas of boards full of different stakeholders have been put in practice in places like Germany or Japan. They usually have proven to be distortive and non-constructive, as, for example, the interests of employees can differ quite dramatically from those of managers and shareholders, and the place to solve these differences might not be the board. Debt, on the other hand, and as has been widely studied[78], has a disciplining effect on managers. Moreover, the objective of the debt holder is also to maintain the financial and structural soundness of the corporation, as the debt holder is a claimant on the assets of the company.

The idea would be to replicate this disciplining effect at the board level. A good example of how this could work is if the CEO wants to do a huge investment project that might increase leverage. The shareholders might enjoy the immediate upside of leveraging the company, but might later suffer the consequences of high debt. Another clear situation could occur when a CEO is reluctant to divest assets in the face of financial troubles because this would hamper the business of the company. The debt holder could push for this initiative, as it might help to reduce debt levels and this could eventually lead to a better stock price. In essence, the basis of this proposal is to foster an environment where dissent is welcome, and where opposing views can eventually lead to better decisions.

Conclusion

Behind the proposals outlined in this paper lies a quantitative proposition of corporate governance. According to a study performed by the Harvard Business School, companies with better corporate governance enjoyed returns 8.5% higher than those run under more dictatorial, autocratic firms[79]. And higher returns are what business is all about. Or isn't it?

76 Top Pay Research Group, 2001 Independent Director Survey.
77 Jeffrey Sonnenfeld, Harvard Business Review, September 2002.
78 Patrick Gaughan, "Mergers, Acquisitions and Corporate Restructuring".
79 Paul Gompers, Harvard Business School.

Appendix

Example 1
Data for CEO compensation (% inc)

		3%	25%	33%
Year	**Net Income**	**Awarded bonus**	**Bonus paid out**	**In escrow account**
1	10,000	100.0	33.0	67.0
2	10,300	103.0	50.7	119.3
3	10,609	106.0	64.8	160.5
4	10,927	109.3	76.2	193.6
5	11,255	112.6	85.5	220.6
6	11,593	115.9	93.4	243.1
7	11,941	119.4	100.2	262.4
8	12,299	123.0	106.2	279.2
9	12,668	126.7	111.6	294.2
10	13,048	130.5	116.6	308.1
Total	114,639	1,146	838	308

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BY BEN THOMPSON

Information Governance

Introduction

A great deal of the corporate governance debate jumps directly to "the solution" with only the barest pause to consider the nature of the problem.

The central difficulty of governance, corporate or otherwise, is the separation of interest in the result from control of its production. Corporate governance is traditionally concerned with the separation of ownership of cash flow from the control of the assets that produce it. Over the last decade, the focus has shifted somewhat to other "stakeholders" - parties interested in results other than the cash flow, but lacking control.

The basic forms of cash flow ownership are equity and debt.[80] Although equity feels like the "natural" form of "ownership", in some situations, it is debt that dominates.[81]

Schleifer and Vishny (1997) quote numerous studies supporting the conclusion that there are two primary elements used in practical corporate governance – legal protection (of investor rights) and concentrated (cash flow) ownership (separate from direct control). The practical need for concentrated ownership seems to be necessitated by shortcomings in legal protection, even in economies that pride themselves on the strength of their governance mechanisms.

80 Tax is excluded because government must be able to enforce tax collection or it cannot call itself a government. Limited exposure requires limited governance.

81 Schleifer and Vishny (1997) argue coherently that debt is the dominant form of ownership in Germany and perhaps Japan – particularly of pubic firms.

The Governance Market

Corporate governance is fundamentally about a market in control. "Owners" (whether debt or equity based) supply funds in order to purchase the rights to future cash flows, taking also some control rights (e.g. the right to vote on the composition of the board of directors). Subsequently, managers supply funds to the "owners", essentially to purchase the continued right to control the cash flow producing assets (of the business).

McMillan (2002) defines five essential elements of functioning markets:

- Information flows smoothly
- Property rights are protected
- People can be trusted to live up to their promises
- Side effects on third parties are curtailed
- Competition is fostered.

THE BASIC FORMS OF CASH FLOW OWNERSHIP ARE EQUITY AND DEBT. ALTHOUGH EQUITY FEELS LIKE THE "NATURAL" FORM OF "OWNERSHIP", IN SOME SITUATIONS, IT IS DEBT THAT DOMINATES

Legal or regulatory support underpins each of these elements, implemented through strong public institutions in most leading economies. In analysing the market failures before during and after the Asian crisis, the IMF has recently acknowledged the importance of strong public institutions[82]. Spectacular failures of corporate governance[83] come back to two of McMillan's five elements – trustworthy managers and information flow.

In a sense, these two elements obviate each other – perfect information flow eliminates the need for trustworthy management; perfectly trustworthy management eliminates the need for information flow. The reality is that the two are mutually interdependent[84].

Human reliability is rather hard to legislate, so strengthening information flow should be the natural focus of improving governance mechanisms.

Reframing Schleifer and Vishny's conclusion, the holes in legal protection are only effectively plugged, in even the best current governance regimes, by large owners who are able to insist upon timely and adequate information flows.

Information Flow

Large corporations are almost uniformly governed through a board "supervising" a CEO. This small group of people typically represents a narrow funnel through which information must pass – from the business about performance and from the owners about objectives.

It is still entirely and demonstrably possible for CEO's to constrict the flow of information to suit their own purposes. Where a single point of failure (e.g. the CEO) can destroy an entire system, steps to reduce the scale of failure must be taken – in this case, improvements to information flow, possibly legislated.

Information flow can be improved in two directions – towards the staff of the corporation and towards the owners.

Senior management, recognizing the power inherent in control of and access to information, typically argue strongly against any proposed release of it. For example, disclosure of something as simple as the cost of goods sold is a comparatively recent phenomenon in financial accounts in Australia because it was successfully argued for a long time that it was important competitive information. The truth is that most interested parties, notably excepting investors, already had sound estimates of the cost of goods sold anyway. Improving the information available to investors likely reduces the cost of capital to firms without any concomitant loss.

In dramatic contrast, Wal*Mart is remarkably open with its associates (employees) in sharing detailed financial data. Well-informed associates consequently make better decisions on behalf of Wal*Mart. From the governance perspective, it is much more difficult for senior (Wal*Mart) management to expropriate the firm's assets when a large number of people see financial data on a regular basis.

Increasing Information Flow

Who should take the lead in increasing information flow? There may be interim costs associated with increased information flow or, just as importantly, the perception of interim costs. In this context, it is difficult to expect senior management to unilaterally take the step.

Regulation is the obvious method – either the relevant government or the relevant market controller (stock exchange) will do. Continuous disclosure regimes are an important step in this direction.

Great care must be taken with the regulatory approach. Every governance crisis brings calls for enormous tightening of accounting rules, eventually leading to a smaller tightening. Yet it is still senior management, and auditors effectively appointed by them, who control the process.

Effective implementation requires a serious mind shift regarding access to the underlying, unedited data. It is true that no one person is likely to have the inclination, knowledge or skills to detect problems but people en masse –whether inside or outside the corporation - are likely to detect all sorts of problems. Taking on the proportions of an urban myth is the story of the security guard who discovered an interest-skimming fraud at a bank because he idly calculated his daily compounding interest by hand during the night shift. Heckscher (1995) discusses a group of empowered and informed American middle managers who solve their plant's overproduction problem by opening up a European market for their product on their own initiative.

In the absence of regulatory action, a strong union might have the same internal effect. After all, employees are often substantially exposed in the event of corporate failure. Unions can and should argue for improved governance.

It is easy to state "open up financial data to employees" but corporations can argue that the expense would be crippling. Wal*Mart provides an example that it is not just possible but beneficial.

So much for internal flow – what about external flow?

Most likely, flow would be better if control were stronger. The effectiveness of concentrated ownership rests largely on the greater ability to demand better information. How do dispersed small owners acquire the same benefits?

82 Prasad et al (2003).
83 Enron, Global Crossing and Worldcom are the very model of a modern major failure, with apologies to Gilbert and Sullivan.
84 This is a version of the Grossman-Stiglitz (1980) paradox – resolved by accepting that some inefficient monitoring and analysis is necessary for the efficient operation of markets.

Once again, regulation is the obvious path. Indeed, regulation has been increasing the timeliness and fullness of information required to be communicated to owners, and to the market at large.

A different approach might work equally as well. Increasing the ability of owners to aggregate and employ their control tools would enable them to insist upon better information in a wide variety of ownership structures.

For example, (legislatively) requiring that shareholder meetings be organised and overseen by independent, regulator-appointed, parties would reduce senior management's ability to direct these meetings to their own ends.

The internet provides an efficient and effective mechanism for co-ordinating and informing small owners (who are typically equity holders). For example, a number of ex-employee activist sites intentionally aim to get "information" in front of investors, or potential investors.

PERFECT INFORMATION FLOW ELIMINATES THE NEED FOR TRUSTWORTHY MANAGEMENT; PERFECTLY TRUSTWORTHY MANAGEMENT ELIMINATES THE NEED FOR INFORMATION FLOW. THE REALITY IS THAT THE TWO ARE MUTUALLY INTERDEPENDENT

Ownerless Corporations

Charkham's 1994 study showed that a number of Germany's largest banks effectively controlled themselves – the standout being Dresdner, which controlled 59.25% of votes in itself.

In this scenario, the board appoints the board. The board has ownership power without having to risk any capital to acquire it. This is really the ultimate bad governance structure. At least a majority owner has capital at risk – the board of an ownerless corporation is much better placed to expropriate.

Financial institutions, such as mutual funds, now effectively control many large public corporations. This prima facie improves corporate governance through concentrating ownership. However, who controls a mutual fund? In practice, it is often the management, not the dispersed investors.

The internet (and regulation) can assist here as well. Institutional investors should gather voting direction from their owners (investors) and vote accordingly (splitting their votes accordingly). This would improve the control available to small owners and therefore their ability to demand information flow and therefore the quality of their decision making.

Conclusion

At its core, there are really only two important corporate governance issues:

- Appropriate, enforceable legislation and regulation
- Timely and appropriate information flow

Strong public institutions, as the implementers of governance legislation, are comparatively well understood – although not uniformly available around the world.

Viewing corporate governance as a market in control leads directly to questions of market design.

Currently, the gaping hole in corporate governance is information governance – the structural support for improving the depth, quality and timeliness of information flow to owners (and other stakeholders).

Piecemeal legislation to address individual symptoms of poor governance, such as excessive CEO compensation, is focusing too tightly on the problem. Plugging one hole figuratively opens another.

The ideal is for the market to be able to decide with integrity and reliability questions such as appropriate levels of CEO compensation. Improving information governance is building a dam, not plugging a hole.

DISCLOSURE OF SOMETHING AS SIMPLE AS THE COST OF GOODS SOLD IS A COMPARATIVELY RECENT PHENOMENON IN FINANCIAL ACCOUNTS IN AUSTRALIA BECAUSE IT WAS SUCCESSFULLY ARGUED FOR A LONG TIME THAT IT WAS IMPORTANT COMPETITIVE INFORMATION

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BY ROBERTO IPPOLITO

Executive Compensation & Corporate Governance

Some Empirical Tests

Introduction

According to a survey of Business Week, the average compensation mix for CEOs in the 1960s was two-thirds salary and one-third incentives, in the 1990s this ratio was the opposite. In this paper, we analyze the different ways in which executives of the S&P 500 have been rewarded in the period 1992-2001 and try to draw some conclusions for corporate governance. In particular, we focus on the role of human capital in a firm and show that executive compensation should take into account not only shareholders, but also all the other stakeholders (bondholders and holders of specialized human capital) whose contribution to the performance of the firm is tantamount important. Also, by comparing different industries, we will show that compensation is affected by the different degree of uncertainty which prevails in each sector. The firm in fact is characterized by a certain number of relationships with different groups (stakeholders) each with the power to affect the firm's performance: stakeholders can be inside the firm (shareholders, employees) but also outside of it (customers, suppliers, lenders). Donaldson-Preston (1995) have explored this line of analysis, also by defining the boundaries of the theory: "...stakeholder management requires, as its key attribute, simultaneous attention to the legitimate interests of all appropriate stakeholders..." (p. 67). The authors were worried, however, to prevent possible extensive interpretation by implying "that all stakeholders should be equally involved in all processes and decisions."

IN PARTICULAR, WE FOCUS ON THE ROLE OF HUMAN CAPITAL IN A FIRM AND SHOW THAT EXECUTIVE COMPENSATION SHOULD TAKE INTO ACCOUNT NOT ONLY SHAREHOLDERS, BUT ALSO ALL THE OTHER STAKEHOLDERS (BONDHOLDERS AND HOLDERS OF SPECIALIZED HUMAN CAPITAL) WHOSE CONTRIBUTION TO THE PERFORMANCE OF THE FIRM IS TANTAMOUNT IMPORTANT

Data description shows that the well known empirical regularity between salary (and bonus) and size of the company is confirmed across nearly all industries. The theoretical literature surveyed predicts that standard deviation and leverage are positively related to compensation. We provided some empirical evidence: some results (namely the ones related to the effect of uncertainty on compensation structure) confirm the predictions, whereas others disconfirm them.

The rest of the paper is organized as follows: section 2 provides an overview of the relevant literature; section 3 sketches the hypothesis to be tested; section 4 describes the data; section 5 offers the empirical results. Finally, the concluding remarks are given in section 6.

Literature Review

The first attempt to incorporate the role of human capital into the literature on the theory of the firm is by Titman (1984) who notes that human capital investments in knowledge are an example of the relationship within the firm which cannot be synthesized in a contract and that the capital structure choice may have an impact in determining the expropriation of some "implicit" claimants (such as workers, customers, suppliers). Once the company goes bankrupt, such relationship gets destroyed as well as the related knowledge. Shleifer - Summers (1988) show that hostile takeovers may entail the abrogation of long-term implicit contracts with employees, leading to reductions in extra marginal wage payments; such actions may deter the formation of long-term employment contracts among other employees, thus further reducing welfare.

HUMAN CAPITAL INVESTMENTS IN KNOWLEDGE ARE AN EXAMPLE OF THE RELATIONSHIP WITHIN THE FIRM WHICH CANNOT BE SYNTHESIZED IN A CONTRACT AND THAT THE CAPITAL STRUCTURE CHOICE MAY HAVE AN IMPACT IN DETERMINING THE EXPROPRIATION OF SOME "IMPLICIT" CLAIMANTS

Helwege (1989), in an implicit contract view of the firm framework, tests for the effects of an increase in the probability of bankruptcy on the shapes of tenure-earnings profiles using CPS data. The costs of liquidation to workers with specific human capital may be important enough for some firms to choose low debt-to-equity ratios. If so, increases in the probability of bankruptcy will be associated with lower levels of investment in specific human capital. Finally, Jaggia-Thakor (1994) note that employees (and in particular managers) are reluctant to acquire firm-specific human capital, though valuable to the organization, since it is costly for the employee in terms of effort and because the skill acquired is not perfectly marketable. The way for the firm to tackle with this problem is to offer the individual a long-term contract that precludes firing or to offer monetary incentives.

"Since employees rationally anticipate this, in assessing the ex ante efficient dynamic wage contract, they factor in the effect of corporate leverage on the likelihood the contract will be honored."

A natural candidate solution to the preservation of human capital is the "purchase" of the firm by managers and/or employees. In an interesting empirical paper, Chaplinsky et al (1998) investigate the motivations for and consequences of including a broad group of employees in leveraged buyouts by comparing employee buyouts (EBO) to management buyouts (MBO) and find that EBOs are more likely when the mechanisms for protecting employees' capital, such as implicit contracts, have become less effective and when firm specific investments enhance productivity. Another possible solution is the Weitzman's (1985) profit-sharing capitalism, also called profit related pay. Weitzman himself, however, in illustrating the features of a profit-sharing capitalism, is very explicit in ruling out any increase in employee participation in decision making (let alone employee ownership) associated with profit sharing. In this sense, profit sharing firms are not participatory firms: they are profit maximizing firms where some agreed upon element of profit is used to pay part of employees' remuneration.

There exists a vast literature (surveyed thoroughly in Murphy, 1999) that analyzes executive compensation. The focus of the analysis is on the alignment of incentives between managers and shareholders, by looking at the sensitivity of executive compensation to shareholder's wealth. The idea that shareholders are the only principals in the executive contracting problem though is too simple.

THE IDEA THAT SHAREHOLDERS ARE THE ONLY PRINCIPALS IN THE EXECUTIVE CONTRACTING PROBLEM THOUGH IS TOO SIMPLE

Fama and Jensen (1983) ask why debt holders shouldn't be included as claimants of the firm's resources and included in the firm's estimates of wealth elasticities. The optimal top-management compensation structure is thus determined by the design and mix of all external claims, not only equity. John - John (1993) analyze the optimal management compensation for the cases when external claims are (1) equity and risky debt, and (2) equity and convertible debt, and find a negative relationship between pay performance sensitivity and leverage. Even for firms with little long-term debt, though, there may be debt-like contractual agreements with fixed claimants such as workers, suppliers, and customers. Fama (1990) has argued that such claims be considered along with traditional financial leverage. Similar to the bondholders, these stakeholders will price their claim in anticipation of the investment choices to be made by management given the compensation contract in place.

Following the above and since neither the level nor the return of investment in firm-specific human capital is directly observable, we use cross section data on cash compensation (i.e. not deferred such as bonus or stock options) to test whether leverage is positively related to cash compensation[85] and standard deviation is negatively related to cash compensation.

Data

Data on S&P 500 executives are from Standard and Poor's ExecuComp and the sample period is 1992- 2001. We do not believe, as the following table that depicts the significance in the exchange representation as of 12/31/2002, that limiting us to the analysis of S&P500 only can impair the results of our analysis.

Table 1
S&P 500 Exchange Representation

	Number of Companies	% of Market Capitalization
NYSE	424	85.7
NASDAQ	74	14.1
AMEX	2	0.2

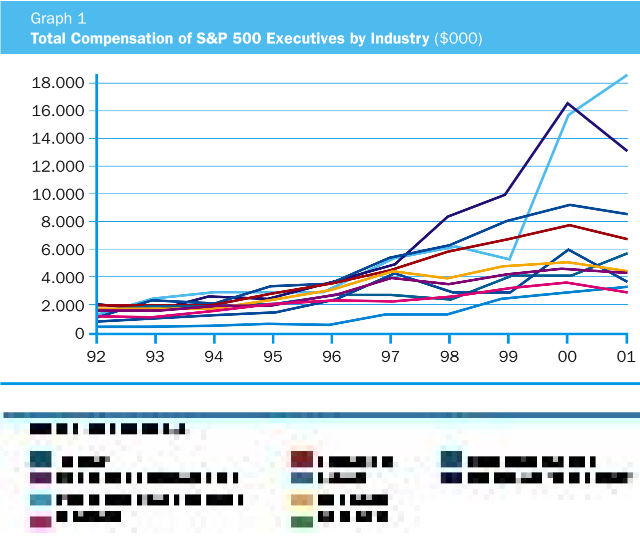
The industry aggregation follows the Global Industry Classification Standard ("GICS"), which distinguishes 10 economic sectors: Energy, Materials, Industrials, Consumer Discretionary, Consumer Staples, Health Care, Financials, Information Technology, Telecommunication Services, and Utilities. The following table shows the GICS composition of the S&P500 as of 12/31/2002:

85 We choose to focus on the cash component since this one is relevant in determining cash flows available to the remaining stakeholders and is not deferred.

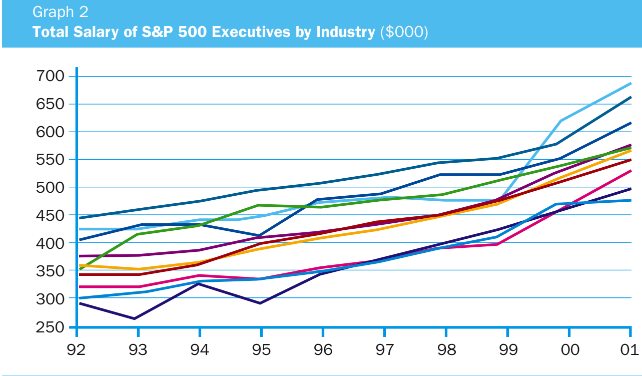
Table 2
S&P 500 Global Industry Classification Standard (GICS) Sectors

	Number of Companies	% of Market Capitalization
Consumer Discretionary	88	13.4
Consumer Staples	34	9.5
Energy	23	6.0
Financials	81	20.5
Health Care	47	14.9
Industrials	67	11.5
Information Technology	77	14.3
Materials	34	2.8
Telecommunication Services	12	4.2
Utilities	37	2.9

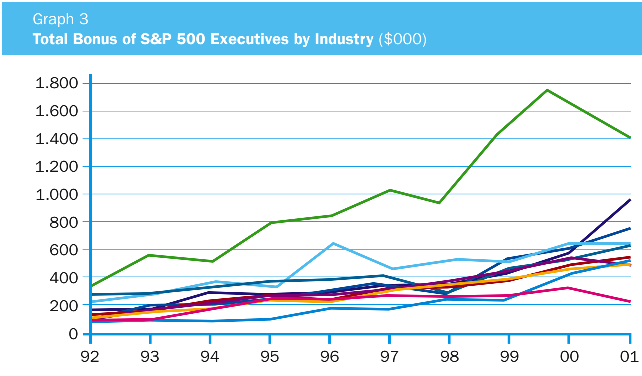
Figure 1 shows the evolution over time of total compensation:



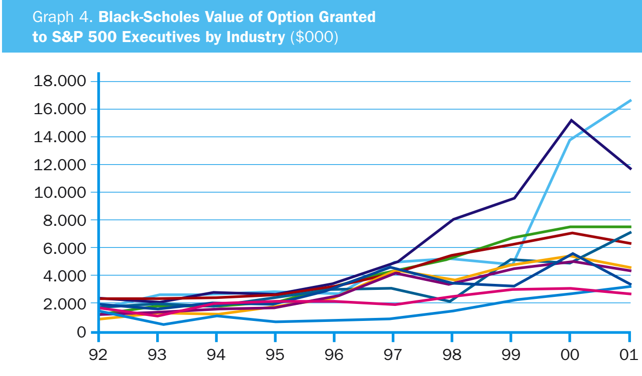
Graph 1
Total Compensation of S&P 500 Executives by Industry ($000)



Graph 2
Total Salary of S&P 500 Executives by Industry ($000)



Graph 3
Total Bonus of S&P 500 Executives by Industry ($000)



Graph 4. **Black-Scholes Value of Option Granted to S&P 500 Executives by Industry** ($000)

A clear fact that emerges from the observation of the previous chart is that total compensations varies across industries. To better understand the differences and for the purposes of this analysis, a firm's compensation policy shall be broken into three independent dimensions: the level, the functional form and the composition. The level is the expected total cost of the pay package to the employer (or the expected total value of the package to the employee[86]). Pay level relates to the organization's competitive position in the market and may also affect employee quality of effort. For jobs staffed primarily from within, it provides information about the relative desirability of developing specific human capital knowledge, skills, and abilities versus general human capital. The functional form of compensation provides the definition of the relation between pay and performance and the definition of performance. The composition of the compensation package defines the relative amounts of the components of the package and can reflect risk aversion among executives. The graphs in the following page show the level of salary, bonus, options in the different industries from 1992 to 2001.

The comparison is still not appropriate since the average firm size varies across industries. This correction is very important since it is a well nown fact that salaries for CEOs are positively related to firm size[87] (traditionally measured using company revenues): the adjustment is made either through size groupings or through simple log-linear regressions of log(salary) on log(size). The results[88] of the regressions[89] are shown in the tables in the next page:

Several stylized facts emerge from the previous graphs and table: there has been a marked increase in the use of stock options, especially

86 It must be noted that the cost of the option to the employer can be substantially different from its value to the employee. In fact, risk aversion plays no role in option-pricing theory since the risk generated by an option can be eliminated with a hedge portfolio. Agency theory however predicts that the employer must prevent this hedging by the employee, otherwise hedging unravels the incentive effects of the option. The wedge between the Black-Scholes cost of options to the employer and the value of non-tradable options to risk-averse executives can be – as shown by Hall-Murphy (2002) - significant.

87 Rosen (1990) and Oi (1983) note that in larger organizations the marginal product of manager's effort is higher because executives contribute also to the productivity of employees below them (span of control effect). The most talented executives are efficiently assigned to control positions in the largest firms where talent and the marginal product of control are complements: the idea is that personal power and influence in an organization depend on the interactions between talent and the productivity of control. If there is complementarity between the two it is efficient to assign greater control to more talented persons. This explains why earnings of top executives in large firms are so large, and why executive pay is positively correlated with firm size.

88 We have omitted the financial services industry due to the non perfect comparability of the size variable. Consistently with the existing literature, we have also omitted the regression stock options on firm size.

89 Throughout the paper we have used pure cross-sectional regressions (i.e. one cross section regression of the time-series averages) to account for industry correlation.

in some sectors[90]; CEOs in highly regulated industries receive lower incentives from stock options award; the well known empirical regularity of the relationship between salary (and bonus) and sales is confirmed across nearly all the industries with relatively little variation in the magnitude of the coefficients.

Table 3
Dependant variable: Log (salary)

Industry	Constant	ln (Sales)
All	5.05 (12.83)	0.13 (6.46)
Consumer Discretionaries	5.39 (17.02)	0.10 (5.12)
Consumer Staples	5.82 (31.53)	0.18 (2.53)
Energy	4.13 (6.19)	0.21 (8.41)
Health care	5.96 (10.97)	0.12 (1.77)
Industrials	4.05 (9.36)	0.18 (2.89)
Information Technology	5.09 (15.51)	0.12 (5.77)
Materials	6.38 (9.47)	0.13 (1.94)
Telecom	5.24 (10.04)	0.13 (10.54)
Utilities	5.76 (13.11)	0.13 (3.70)

Table 4
Dependant variable: Log (bonus)

Industry	Constant	ln(Sales)
All	3.67 (11.43)	0.14 (9.83)
Consumer Discretionaries	4.04 (11.33)	0.11 (3.31)
Consumer Staples	5.35 (11.71)	0.07 (2.21)
Energy	4.29 (6.07)	0.09 (2.66)
Health care	5.44 (4.85)	0.12 (1.68)
Industrials	3.59 (1.72)	0.01(15.41)
Information Technology	2.72 (7.18)	0.18 (4.49)
Materials	5.01 (9.78)	0.04 (0.85)
Telecom	3.17 (6.85)	0.18 (6.99)
Utilities	5.51 (12.68)	0.09 (0.33)

Results

Summary[91] statistics is shown below. The variables are so defined: CashCompRatio is the ratio of salary to total compensation, and StDev is the annual standard deviation of stock return for each individual company.

Table 5
Summary Statistics

Variable	N	Mean	Median	St. Dev	Min	Max
CashCompRatio	342	0.0044	0.0032	0.0039	0.0000	0.0377
Debt / Total Assets	342	0.4436	0.1596	1.9485	0.0000	0.8281
Standard Deviation	342	0.5521	0.5300	0.1159	0.3271	1.1251

The following table shows the results of our regressions.

Table 6
Dependant Variable: CashCompRatio

Industry dummies	yes	yes	yes
Debt/Total Assets	0.0001	0.0001	
(t-stat adj)	(1.3899)	(1.3943)	
St. Dev.	-0.0040		-0.0040
(t-stat adj)	(-1.9625)		(-1.9657)

Debt does not appear to play any role (all coefficients are insignificant): this result - though different form what we expected - is not completely surprising, since most of the studies that report a relationship between compensation structure and leverage are related to firm in distress.

THE RESULT ALSO TENDS TO VALIDATE THE HYPOTHESIS OF MANAGER'S RISK NEUTRALITY. WHEN THE WORKER IS RISK AVERSE, IN FACT, A HIGHER STOCK RETURN VARIABILITY ALSO INCREASES THE MANAGER'S RISK EXPOSURE WHICH SHOULD LEAD TO A HIGHER RISK PREMIUM TO COMPENSATE THE MANAGER FOR THIS ADDED RISK

Standard deviation confirms our theoretical predictions. It is significant when used as the only explanatory variable (along with the usual industry dummies) and in association with D/A. Consistently with what predicted, a higher variability tends to increase the use of non-cash compensation items. The result also tends to validate the hypothesis of manager's risk neutrality. When the worker is risk averse, in fact, a higher stock return variability also increases the manager's risk exposure which should lead to a higher risk premium to compensate the manager for this added risk.

THERE HAS BEEN A MARKED INCREASE IN THE USE OF STOCK OPTIONS, ESPECIALLY IN SOME SECTORS; CEOs IN HIGHLY REGULATED INDUSTRIES RECEIVE LOWER INCENTIVES FROM STOCK OPTIONS AWARD

Conclusions

Specialized skills, monitoring costs and information asymmetries can result in inefficient labor contracts. Employee ownership and profit related pay can be part of an efficient labor contract that induces employees to make firm-specific investments in the future.

Purpose of this paper has been to show – both theoretically and empirically – that when significant liquidation costs are associated on human capital, people will choose a compensation structure to reflect the possible losses stemming from liquidation. Interesting insights for executive compensation and corporate governance can be drawn from the analysis: we have show that salary and bonus are positively related to size of the firm and that the cash component of the compensation is negatively related to standard deviation of stock. It is a well documented fact that increasing the size of the firm does not necessarily increase the value of the firm, hence the wealth of its shareholders. It is also a well known fact that giving equity related incentives may have undesired (or perverse) effects in the choice of projects: namely a manager may choose a pattern of actions or projects with higher variance to induce his stock options to be in the money. Other interesting lessons can be learnt also from other stakeholders: in particular banks and bondholders may be interested in having a word in the structure of executive compensation, so as to avoid the above mentioned effects. Finally, human capitalists (managers) may be interested in having more pure equity as opposed to equity-style compensation if they care about their endowment of knowledge and experience.

90 Stock options may have increased for many reasons: political and media pressures to link reward to performance after the excesses of the 80ies, a mechanical explanation given by the fact that the number of stock options is determined under a fixed-value or fixed-share basis exacerbated by the bull market, and a behavioral explanation that reflects the increased executive acceptance of stock options caused by two decades of bull market.

91 Companies that are included in our database must fulfil the requirement of having ten consecutive years of data: thus, given the initial 500 companies, we have restricted our analysis to 342 companies. The resulting sample represents 90% of the original one in terms of market capitalization.

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Dynamic Compensation Model

A new way of looking at the CEO's compensation

Abstract
In the present scenario one big problem facing organizations is how to integrate corporate governance into their culture. This paper proposes a model called "Dynamic Compensation model" which rationalizes the compensation structure of the CEO, based on rational targets set out of the forecasted results of the organization. This model is dynamic in nature as it can absorb fluctuations in external and internal factors, which get reflected in the modified targets. This model can initiate a change process in the organization towards a state of self-governance at all levels of the organization.

Introduction
The role of a leader, CEO or head of an organization has assumed immense importance for the growth, sustainability and competitiveness of a modern day organization. The organization immensely benefits from the presence of a competent and motivated CEO. Hence, corporate governance which essentially investigates the means of securing /motivating the efficient management of an organization has assumed great importance in organizations throughout the world today.
However, corporate governance will be at its best when there is no corporate governance. In most companies the CEO is generally forced to think short-term. Today, most of the CEO's compensation packages are linked with the financial performance of the company (as reflected by the movement of the company's stock price). This puts an undue pressure on the CEO and induces him into tempering and channeling the funds of the organization. Fudging of the company's financial statements is also a common accusation against the CEO. This usually results in a nexus between the auditors and the top management of the company and can lead to the complete collapse of a company as seen in the cases like Enron, WorldCom etc. This paper aims at proposing a framework for the compensation of a CEO which spurs him to give his best to the organization and at the same time deters him from adopting false means to boost the performance indicators of the organization.

Dynamic Compensation Model
The various elements of the model are described as below:

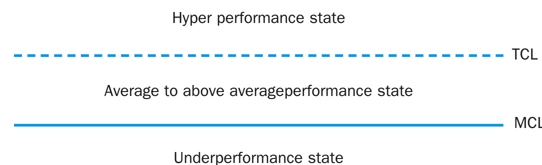
Concept of Critical Energy
Every organization has a series of developmental phases through which the organization grows and expands. However, the growth of any organization is affected by both its external and internal factors. In a booming economy, an organization may be able to do reasonably well without the CEO playing a very important role. However, in a recessionary economy; the organization may require key strategic guidance from the CEO, to prevent it from floundering at various phases. The skills of the CEO are put to a true test in such situations.

Every organization has two distinct zones separated by criticality level- above and below the minimum critical level (MCL). When an organiza-

tion is at its minimum critical level (MCL), it has the bare minimum energy required for an average performance. As the energy level in the organization increases, so does the performance of the organization. As the organization reaches the threshold critical level (TCL), the entire organization is in a state of hyper performance with every single employee of the organization swept by this wave of energy.

The performance of the organization in this state is attributable to only and only the internal dynamics in the organization. Thus other factors such as an increased demand for the company's products, boom in the economy etc. are not attributable to the improved performance of the organization. An important aspect to be noted is that the TCL is always above the MCL of the organization.
The various critical levels and the performance of the organization at these levels is shown in Figure 1.

Figure 1
Critical states of an organization



The Minimum Critical Level of the organization represents the energy required by the organization for an average performance under the micro/macro environmental conditions. It can be quantified by expressing in terms of the sales revenue, EBIT, EAT or any other performance indicator found suitable by the organization. Both MCL and Threshold Critical Level are set using the same performance indicators.

EVERY ORGANIZATION HAS TWO DISTINCT ZONES SEPARATED BY CRITICALITY LEVEL-ABOVE AND BELOW THE MINIMUM CRITICAL LEVEL (MCL)

Consider two scenarios: 1) The demand for the product manufactured by a company is huge and the entire industry is growing at a rapid pace, 2) The demand for the product manufactured by the company is low and the entire industry is showing negative growth rates. The MCL for an organization in scenario 1 is higher than in scenario 2. As the product is in its growing phase in scenario 1, a performance which can be termed average is said to occur at a sales revenue of Rs.X. In scenario 2 the company may be said to have achieved an average performance at a sales revenue of Rs.Y. Rs.X is always higher than Rs.Y. Thus a performance which is considered to be average in a booming economy may be considered above average in a recessionary economy.

We contend that the top management especially the CEO has a key role in ensuring that this energy is generated and built up in the organization. The policies and the guidance of the top management go a long way in ensuring that the entire organization is geared up to perform at its peak level. Hence, it is natural to link the variable component of the CEO's compensation to the critical energy generated in the organization.

Setting targets

It is suggested that a one year forecast of the company's performance under the present scenario be taken into account and set as the base performance level (BPL) for the CEO. This is the predicted performance of the organization if the present conditions hold good at Minimum Critical Level of the organization. This target should be set objectively in consultation with the board members and the concerned CEO himself. The performance indicator used by the organization for setting the MCL should also be used for setting the BPL.

WE CONTEND THAT THE TOP MANAGEMENT ESPECIALLY THE CEO HAS A KEY ROLE IN ENSURING THAT THIS ENERGY IS GENERATED AND BUILT UP IN THE ORGANIZATION

Performance Mapping

If the performance of the organization falls below the forecasted performance (i.e. below the MCL) the CEO does not deserve a raise in his compensation. This will happen if the organization is not able to reach/sustain its MCL. A reasonable raise in the compensation may accompany performance levels beyond the MCL but within the Threshold Critical Level.
It is contended that any increase in the region between the MCL and the TCL, is followed by a linear increase in performance. As such the compensation of the CEO should also vary in a linear fashion in this region.

However, as the organization crosses the Threshold Critical Level there will an exponential increase in the performance of the organization. As the CEO has a major role in taking the organization to/beyond the minimum threshold level, any improvement in the organization's performance beyond the MCL should result in a hefty compensation rise for the CEO. This formula should be customized to each organization and there cannot be a generic formula which can be used by all organizations.

Base lining of the Minimum Critical Level

The MCL of the organization varies with the development phase of the organization. The MCL of an organization in its infancy will not be the same as the MCL of a well established organization.
As the organization grows, processes evolve which makes the organization more streamlined in its functioning. As people become more and more skilled in their functions, the performance of the organization improves. The MCL of the organization too shows an increase indicating that minimal effort is required to achieve performance standards set at MCL.

HOWEVER, AS THE ORGANIZATION CROSSES THE THRESHOLD CRITICAL LEVEL THERE WILL AN EXPONENTIAL INCREASE IN THE PERFORMANCE OF THE ORGANIZATION

The base lining of the MCL should be done at regular intervals. These intervals vary depending on the nature of the organization. For a software company this could vary from 2-3 years whereas for a manufacturing company it could vary between 3-5 years. It is suggested that the experts in the sector be consulted to arrive at the MCL. Their knowledge about other organizations in the same sector should also be used in setting up the MCL figures.

Other Features of the Dynamic Compensation Model

Dynamic leveling

As described, the cut-off levels would be set at the beginning of the year based on the forecast of intensity of business in the coming year. It is quite possible that macro-economic and environmental conditions would change unexpectedly as the year progresses. In such a scenario, the targets at MCL should be revised. It is proposed that this review be done every quarter by an independent panel of members. This panel should be impartial and well supported by the top management.

THOUGH THE MODEL TAKES INTO ACCOUNT THE INFLUENCE OF EXOGENOUS FACTORS ON THE PERFORMANCE OF THE FIRM, THE CEO MIGHT STILL RESORT TO UNETHICAL PRACTICES TO DISTORT THE RESULT IN HIS FAVOR

Cross-Checking of reported results

Though the model takes into account the influence of exogenous factors on the performance of the firm, the CEO might still resort to unethical practices to distort the result in his favor. Such acts can be curbed effectively by:

A Probing into the functioning of the company at strategic as well as operational level. This will give the Board of Directors a clear picture as to why the company is showing upwardly biased results. If in the process any suspicious transactions are observed, the CEO should be asked to clarify them.

B Keeping in touch with the operational level employees at regular intervals will let the Board acquaint itself with the ground realities. Generally it has been found that operational employees have relevant information which is filtered up the hierarchy and hence invisible to the Board. The independent panel can again look into these matters and make suitable recommendations.

Limitations of the Model

The limitations of the model are:

1. It requires top-management commitment to give priority to the process and pursue it diligently.
2. The company has to fall back on past performance in various scenarios for setting the cut-off limits. Though this procedure is not accurate, it will give them an estimate of what to expect in the coming year.

Conclusion

As we have already stated the best form of corporate governance is no corporate governance, hence no matter whatever model or framework the company uses, its goal should be to integrate the concept of corporate governance into the organization culture. The Board of Directors can do this by sending strong signals about the dedication of the company to conduct business in the most ethical manner. The underlying objective in such cases should be to maximize the benefits accrued to all the stakeholders and not only the shareholders. The "Dynamic Compensation Model" is a right step in the above direction, which the Board of Directors can use to send signals to the CEO that expectations out of him are quite rational and that the company would recognize any extra effort put in to take the company to greater levels. We expect that this model will slowly phase out the urge for the CEO to resort to unethical means to achieve unjustified results. Once this message is well accepted by the CEO and implemented, strong signals will percolate down to lower management levels to conduct business in the ethical manner, as expectations out of them are rational under the prevailing conditions.

The efficacy of the "Dynamic Compensation Model" will be proven with time and with continuous fine-tuning to suit to specific industry needs and market situation. We believe that this base model will give the organizations a framework to structure their compensation system and start a journey towards "corporate governance integrated organization".

KEEPING IN TOUCH WITH THE OPERATIONAL LEVEL EMPLOYEES AT REGULAR INTERVALS WILL LET THE BOARD ACQUAINT ITSELF WITH THE GROUND REALITIES

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Enhancing Corporate Governance through Diversity:

A Group Dynamics Perspective

Introduction

Corporate governance has recently been the focus of major reviews around the globe – courtesy, to some extent, of the scandals that have shaken up company boardrooms. Out of the ashes of the much-publicised Enron fiasco came the Sarbanes-Oxley Act, which requires all American companies to have an independent audit committee. Similarly in Australia, the collapse of insurer HIH prompted outrage when directors pleaded ignorance to the mismanagement leading to the firm's demise. The Australian Stock Exchange (ASX) has since convened a Corporate Governance Council to develop guidelines for reform. Meanwhile in the UK, the government adopted all of the recommendations from the Higgs review of non-executive directors and the Smith report on audit committees.

These reviews of corporate governance are asking fundamental questions, focused largely on the structural composition and role of boards, including: What is the role of independent directors? How many should there be? What exactly do we mean by 'independent'? Should the CEO also be Chairman? How many directorships should an individual be allowed to hold at once?

As the repercussions from the reviews are being felt, it is timely to step back and evaluate the underlying issues that impact the performance of boards. Derek Higgs asserted in his UK study of non-executive directors that "effective boards depend on the best people and on their behaviours and relationships"[92]. It is critically important, of course, to codify the boundaries in which boards operate, but these comprise only one side of the story. Appropriate behaviours and relationships on boards cannot be mandated – they have to be built. And doing this requires an understanding of the 'softer' aspects of board performance.

This paper argues that directors, companies, and society as a whole will benefit from a broader rethinking of board composition. Boards shall be examined from a group dynamics perspective, with the argument that stepping away from today's relatively homogenous pool of directors will be critical to overcoming the barriers that impede effective behaviours and relationships.

Reviewing the Concept of Corporate Governance

In common parlance, corporate governance typically describes the way the board of directors regulates a company's management. However, there is no consensus on the exact definition – a review by Turnball[93] cites a range of expert definitions, including Donaldson's "the structure whereby managers at the organisational apex are controlled through the board of directors, its associated structures, executive incentive, and other schemes of monitoring and bonding" and Demb & Neubauer's "the process by which corporations are made responsive to the rights and wishes of stakeholders".

APPROPRIATE BEHAVIOURS AND RELATIONSHIPS ON BOARDS CANNOT BE MANDATED – THEY HAVE TO BE BUILT. AND DOING THIS REQUIRES AN UNDERSTANDING OF THE 'SOFTER' ASPECTS OF BOARD PERFORMANCE

It is important to note that board structures differ considerably between countries. *The unitary board* is standard for large companies in Australia, UK, US, and other Anglo nations, while *compound* or *tiered* boards are required by law in some European countries (such as Germany), and also found throughout Asia (for instance Japan). The focus of this paper is the unitary board structure. Even within the unitary structure, approaches often differ between countries – for example, American companies often combine the CEO and Chairman roles, whereas these two roles are usually kept separate in Australia and the UK (although the CEO is still a board member). The primary purpose of a unitary board is one of oversight, with directors owing "fiduciary duties, including the duties of care and loyalty, to the corporation"[94].

92 Derek Higgs, "Higgs Sets Out Agenda for Change in Boardroom" (press release for Higgs' Review of the Role and Effectiveness of Non-Executive Directors, January 2003).
93 Shann Turnball, "Corporate Governance: Its Scope, Concerns and Theories", Corporate Governance: Scholarly Research and Theory Papers 5 (1997) 180-205.
94 John Alan Cohan, "'I didn't know' and 'I was only doing my job': Has Corporate Governance Careened Out of Control? A Case Study of Enron's Information Myopia", Journal of Business Ethics 40 (2002) 275-299.

The recent Higgs Review in the UK outlined the role of the board as being "collectively responsible for promoting the success of the company by directing and supervising the company's affairs"[95]. But it is not entirely clear what these fiduciary duties entail. Should boards seek solely to maximise shareholder value, or are there wider responsibilities to other stakeholders affected by the company's operations?

The shareholder-primacy model has dominated in recent decades, but there are several problems with this: "Which shareholders ought to be the focus of maximising shareholder wealth? Shareholders of the moment? Long term shareholders?"[94] Cohan argues that "the profitability of stockholders and ethical concerns are not inherently separate and apart", concluding that "the duties of the board entail focusing on a panoply of concerns, above and beyond maximising shareholder profits"[94].

Certainly, it is clear that the value of *good corporate citizenship* is increasingly valued in the wider community, and even codified into regulations. The Higgs Review asserted that "the board should set the company's values and standards, and ensure that its obligations to shareholders and others are met"[95]. The ASX Corporate Governance Council also recognises the importance of stakeholder interests, including amongst its ten essential principles of corporate governance the requirements of "promoting ethical and responsible decision making" and "recognising the legal rights of stakeholders"[96].

The Dynamics of Teams

Teams play a vital role in all parts of the modern corporation, but it is at the very top of the organisation that effective team behaviour is most critical. Behaviours and relationships amongst company boards and management teams can have far-reaching implications (for good or for ill) throughout the organisation, as well as for shareholders and other stakeholders.

Several examples of ineffective board behaviour were described in a recent article looking at the so-called "sheep and robins" syndrome.[97] The article's author, Paul Kerin, identifies four sorts of directors: (i) a small percentage who lack the required capabilities (ii) *sheep*, who blindly follow the chairperson or the flock (iii) *robins*, who vigorously defend their nest against interlopers, and (iv) the rest, who look out for shareholder interests in a professional and objective fashion. Kerin argues that value-destroying behaviour by boards is often attributable to sheep and robin behaviours, which have as their root cause a failure to deal appropriately with the "soft" factors – "the less visible but crucially important things that underlie how boards really work in practice, such as how they interact, manage conflict and make – or don't make – decisions as a group"[97].

It is worthwhile, therefore, to examine in more detail the nature of group interaction – to look more closely at the soft factors and the problems that arise when they are not handled properly. This has important implications for the composition, structure, training, and performance measurement of company boards.

First, we should distinguish between *teams* and *groups*, because the word 'team' is frequently used incorrectly. Many so-called work teams are actually just groups (though we would very much like them to be teams!) Work groups share information in pursuit of an objective, contribute different skills and perspectives, and are individually accountable. Teams, however, are a special subset of groups in which all members strive towards a common goal, have complementary skills, are both individually and mutually accountable, and together accomplish more than the sum of their individual contributions.[98] Clearly, it is in a company's best interest for the board of directors and the senior management groups to operate and cooperate as high-performing teams.

A critical element that enables team performance is information flow. Experts on team performance suggest that teams "should be challenged regularly with fresh facts and information … teams err when they assume that all the information needed exists in their collective experience and knowledge"[99]. This is particularly relevant for boards and management teams. One major risk is that the necessary information is not provided – it may be concealed, distorted, delayed or blocked (either deliberately or unconsciously). Clearly, some filtering of information is necessary lest the directors and management be overwhelmed. But subordinates are often tempted to "report to the boss what one perceives the boss wants to hear"[94]. At the extreme end (such as Enron) "distortion or concealment can become a dominant strategy regardless of explicit injunctions of senior management to 'give me accurate information', if workers fear the possibility of being fired or deadended in light of a candid portrayal of a situation"[94].

Another difficulty faced by boards and management teams is the conscious and subconscious behaviours that occur after receiving new information. Problems can arise at this point due to *cognitive dissonance*, since "the human mind has an innate drive to maintain consistency between its preexisting attitudes and the information it receives"[94]. This can manifest itself in various ways, including being more likely to notice information that confirms existing beliefs, explicitly disregarding evidence that contradicts existing beliefs, using a biased thought process to arrive at a favoured outcome, or a reluctance (despite strong evidence) to admit an idea or course of action is incorrect.

PROBLEMS CAN ARISE AT THIS POINT DUE TO COGNITIVE DISSONANCE, SINCE "THE HUMAN MIND HAS AN INNATE DRIVE TO MAINTAIN CONSISTENCY BETWEEN ITS PREEXISTING ATTITUDES AND THE INFORMATION IT RECEIVES"

Ironically, the greatest barriers to board performance often arise out of their strengths. Strong group cohesion and a record of previous success can often lead to *groupthink*[101]. This phenomenon has been implicated in many team dysfunctions, most notably the decision to launch space shuttle Challenger on a cold morning despite significant evidence of problems in cold conditions[100]. Groupthink arises in stressful or crisis situations where there is directive leadership and a highly cohesive but insulated group[101]. Dissenters can find themselves confronted with direct pressure to conform, or sometimes apply self-censorship before direct pressure occurs. There is frequently an illusion of unanimity, and a collective reluctance to accept evidence that challenges the group's thinking. An illusion of invulnerability stemming from previous successes is another precursor to *groupthink*[101].

Remuneration of Management and Boards

A Booz Allen Hamilton study in conjunction with the World Economic Forum identified a company's *alignment* and *adaptability* as critical dimensions in determining its performance[102]. Alignment refers to common objectives, shared understanding, consistent motivation, and supportive processes. Adaptability, on the other hand, emphasises objective evaluation of information, experimentation and tolerance of failure, a focus on learning,

95 Derek Higgs, Review of the Role and Effectiveness of Non-Executive Directors (commissioned by the UK government, January 2003).
96 Fiona Buffini, "Reforms Set on Board Table", The Australian Financial Review, 20 February 2003.
97 Paul Kerin, "Baaanish Boardroom Sheep", The Australian Financial Review, 20 February 2003.
98 Stephen Robbins et al., Organisational Behaviour (New York, Prentice Hall, 1998).
99 Jon Katzenbach and Douglas Smith, "The Art of Making Togetherness Work", The Australian Financial Review, 11 September 2001.
100 Gregory Moorhead, Richard Ference, and Chris Neck, "Group Decision Fiascoes Continue: Challenger and a Revised Groupthink Framework", Human Relations 44 (1991) 539.
101 Irving Janis and Leon Mann, Decision Making: A Psychological Analysis of Conflict, Choice, and Commitment (New York, The Free Press, 1977).
102 Booz Allen Hamilton and World Economic Forum, Creating the Organizational Capacity for Renewal (2000).

and a rapid response to change. Comparing these characteristics to the precursors of groupthink, it is clear that a highly aligned organisation with low adaptability is more susceptible, since it lacks the "constructive scepticism"[103] exhibited by effective boards.

Incentives and remuneration are often focused on rewarding alignment and outcomes, but not adaptability. Stock options and large performance bonuses linked to the share price can create a commonality of objectives and motivation in the management team. However, with so much at stake, the CEO and management team may discourage any debate or dissent that delays or disrupts progress, particularly since share prices are notoriously responsive to a perceived lack of progress or a change in direction. This is a typical groupthink outcome, with high group cohesion, strong leadership and a stressful situation resulting in powerful alignment, but very poor adaptability. This is neatly summarised by Warren Buffet's recent criticism "As stock prices went up, the behavioural norms of managers went down"[104].

HOMOGENEITY MAY FOSTER COHESION IN A GROUP, BUT CAN ALSO ENCOURAGE GROUPTHINK AND COGNITIVE DISSONANCE

Presumably a major element of the board's oversight role is to critically evaluate management decision making on key strategic issues. If so, then the board of directors has a duty to prevent groupthink and cognitive dissonance. Herein lies the paradox: Boards are responsible for promoting the success of the company but this requires criticism and dissent from management opinion. Fortunately, the paradox vanishes if we focus less on *getting quickly to the chosen result* and more on *getting to the right result* – that is, to value critical evaluation of ideas and effective decision-making more than monotonic progress towards a favoured but less rigorously tested objective. Naturally, dissent and debate needs to be conducted in an appropriate constructive fashion.

This also raises the question of board remuneration. How do we encourage directors to play the demanding role of devil's advocate, and still compensate them for the increasing risks[105] they face as directors. Stock options and bonus shares offer considerable wealth, but then director remuneration strongly resembles management incentives. We would then run the risk of cognitive dissonance impacting both the board and the management team– a perilous outcome indeed! The recent collapse of insurance group HIH in Australia illustrates this scenario, with management and board charging forward, dismissive or ignorant of contrary evidence, toward disaster[106]. The subsequent dissection of events highlighted the board's failure to actively question, critique, and evaluate the information and decisions in front of them. Ignorance is no excuse.

How then should boards be remunerated? The guiding principle needs to be *in a way that encourages adaptability and critical oversight*. Stock options and bonus shares appear unsatisfactory, as explained earlier. A simple salary arrangement may be best, relying on the director's sense of duty and his or her reputation to ensure appropriate behaviour. Certainly, this is a case where 'hard' (structural) tactics probably won't work, and we need to inculcate the desired practices in boards via selection, training and fostering the right culture.

Boosting Diversity on Boards

An important but under-appreciated dimension of board composition is the diversity of its members. The focus of director selection has traditionally been on skills and expertise, but through a relatively narrow lens – white, male, former executives of large corporates. Recent statistics from the UK suggest that 96% of directorships in listed companies are held by men[107]. It is no surprise that the UK's Higgs Review recommended widening the traditional pool of candidates for directorship.[95]

From a group dynamics perspective, there are strong reasons to support greater diversity on boards (diversity here is interpreted as covering all aspects of an individual – gender, race, experience, personality, perspective, and so on). Homogeneity may foster cohesion in a group, but can also encourage groupthink and cognitive dissonance. Diversity, on the other hand, may make the process more uncomfortable and time consuming, but is ultimately conducive to achieving a better result. Research shows that diverse teams are more effective decision-makers in many situations, such as designing new market offerings[108]. Boards of directors deal with complex questions and need to develop solutions that benefit a wide variety of stakeholders – it is therefore inherently sensible to have a board comprised of members that understand the various issues and perspectives involved. A diverse board stands a better chance of doing this than a homogenous one, although it may take longer to arrive at a decision.

Clearly, a major limiting factor for greater board diversity is the business experience and knowledge of those who could otherwise make valuable contributions to the critical evaluation and debate processes. But this is not a reason to abandon increased diversity. Rather, it highlights the need to improve induction and training of directors in order to leverage the broader pool of valuable candidates.

Where to Now?

Over the past year or so, public debate on corporate governance has played a valuable role in highlighting the concerns of stakeholders. Recent formal reviews, such as those in the UK and Australia, are a further opportunity to reconsider corporate governance practices. However, there is a risk that reform is purely structural, such as mandating the number of independent directors, or redesigning incentive structures. Attention also needs to be focussed on the less tangible (or 'soft') aspects of corporate governance – the behaviours and interactions that ensure effective decision-making and review. Improving corporate governance will require a rethinking of board composition regarding diversity, as well as enhanced induction and training programs for potential directors.

103 Paul Kocourek, Christian Burger, and Bill Birchard, "Corporate Governance: Hard Facts About Soft Behaviours", Strategy + Business 30 (2003).
104 Warren Buffet, "Chairman's Letter", Berkshire Hathaway Inc. 2002 Annual Report (2002).
105 "The Way We Govern Now", The Economist, 11 January 2003, 59-61.
106 Tony McLean, Delisted - Search [Web page]. 2003 [cited 30 March 2003]. Available from http://www.delisted.com.au/CompanyDisplay.aspx?ID=365&Company=hih#.
107 Hemscott Group, The Current Population of Non-Executive Directors (commissioned for Higgs' Review of the Role and Effectiveness of Non-Executive Directors, January 2003).
108 Philip Kotler, Marketing Management 11th ed. (New Jersey, Pearson Education, 2003).

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ESADE MBA BUSINESS REVIEW 2003

3. PARTICIPANTS, ABOUT ESADE BUSINESS SCHOOL AND THE TEAM

Participants of the ESADE MBA Business Review 2003

Nearly 200 MBA students having 35 different nationalities and coming from 27 Business Schools spread across 5 continents and 13 countries participated in the ESADE MBA Business Review 2003.

AMERICAS

United States of America

Johnson Graduate School of Management
Cornell University

The Wharton School
University of Pennsylvania

The Graduate School of Business
The University of Chicago

Marshall School of Business
University of Southern California

Leonard N. Stern School of Business
New York University

Kenan-Flagler Business School
University of North Carolina,
Chapel Hill

John M. Olin School of Business
Washington University

Haas School of Business
University of California at Berkeley

Robert H. Smith School of Business
University of Maryland

Thunderbird, The American Graduate School of International Management

EUROPE

The Netherlands

Rotterdam School of Management
Erasmus University of Rotterdam

France

HEC School of Management

Germany

Stuttgart Institute of Management and Technology

Spain

Instituto de Empresa

Belgium

Solvay Business School

United Kingdom

London Business School

Warwick Business School
University of Warwick

Lancaster University Management School

Cranfield School of Management
Cranfield University

Italy

SDA Bocconi
Bocconi University

ASIA

India

Indian Institute of Management, Ahmedabad

Indian Institute of Management, Bangalore

China

China Europe International Business School

The Chinese University of Hong Kong

Singapore

National University of Singapore

AFRICA

South-Africa

Wits Business School
University of the Witwatersrand

AUSTRALIA

Australia

Melbourne Business School
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About ESADE Business School

ESADE is widely recognized to have one of Europe's most prestigious business schools. It features facilities in Barcelona and Madrid.
With over 40 years of experience, ESADE has always been a leader in the commitment to new management values, proving its ongoing willingness to adapt to the professional world's needs. Comprehensive training of the individual and the development of management competencies are central elements of the ESADE Business School training proposal.

Its international outlook, the quality of all its programs, its faculty and its teaching methodologies have earned it the three prestigious international accreditations that constitute the so-called triple crown (AMBA, AACSB & EQUIS) with the sector's most renowned international bodies. The most relevant media sources give ESADE Business School a preferential ranking among international business schools: according to The Wall Street Journal, it is Europe's second best business school.

A network of international relations has been and continues to be a fundamental buttress of ESADE Business School, which maintains agreements for co-operation with over 100 universities and business schools over the five continents; a fact that has given way to the highest level of student, professor and information exchange.

One of the main values of ESADE's MBA Program is the cultural, academic and professional diversity of its participants. This diversity is undoubtedly one of the most exciting aspects of its open and international learning atmosphere, which fosters a continuous exchange of experiences.

The last batch at the ESADE MBA consists of 83% international students and, at the start of the program, had an average age of 28.3 years and an average of 5.1 years of work experience. For further information on ESADE, please visit www.esade.edu.

Team of the ESADE MBA Business Review

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Darpan Sanghvi is a Mechanical Engineer from India & is pursuing a Double MBA (class of 2004) conferred simultaneously by ESADE Business School & McCombs Business School, Univ of Texas - Austin. He has been selected as amongst the top 7 Student Leaders of the World (2003) by the Graduate Business Foundation (USA). Darpan has been an entrepreneur & has also worked as Regional Head of Marketing & Biz Dev (Pune, India) with one of India's heaviest funded dotcoms. <d.sanghvi@esade.edu>

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Mark Wetzels obtained an M.Sc degree in Business Administration from the Rotterdam School of Management. He is currently a full-time MBA student (class of 2004) at ESADE Business School, Barcelona and will attend the exchange program with the NYU Stern School of Business in the fall semester of 2003. Prior to enrolling in the MBA he worked as an Associate at Gilde Investment Management - a major European Private Equity Fund. Mark has also been an entrepreneur for 5 years. <m.wetzels@esade.edu>

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Tracing a circuitous path through first the English department of Harvard University in the US and then the Ministry of Information, Communications and the Arts of the Civil Service in Singapore, Roland finally finds himself in Barcelona pursuing an MBA at ESADE, where he has discovered a hidden talent for numbers and plans to write that first novel that his friends are eagerly anticipating. <r.tan@esade.edu>

Besides the team mentioned above, the ESADE MBA Business Review would not have been possible without the continuous support of their colleagues in their class. The team would especially like to thank Alexandro Arias, Cesar Prado and Alicia Oriol (ESADE MBA class of 2004) for their important contributions to this project.

In addition to all the students, this idea would not have seen the light of the day had it not been for the continuous support of the Management of ESADE Business School. We would like to especially thank Prof. Jaume Hugas – Director of the ESADE MBA for his constant encouragement and motivation to all the team members. Besides Prof Hugas, Nuria Guilera – Director of Admissions of ESADE Business School, Betsy Tufano – Program Manager of the ESADE MBA (Full Time), Colin McElwee – Director of Corporate Marketing and Communications of ESADE, Gemma Martín – Press Departament, Theresa Desuyo – International Programs Manager at ESADE Business School and Oscar Bistué, have all made invaluable contributions to support all the team members of this project.

And finally, we would like to mention once again the most important elements of the ESADE MBA Business Review – the panel of experts who analyzed & judged the papers that we received and based on their analysis wrote the two insightful articles that are found at the beginning of this journal. The panel of experts comprised of the following three Professors along with their teams: Prof Simon Dolan, Prof Miguel Trias and Prof J Brunat.

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