Keynote Speech: No 1
Redesigning Corporate Governance
Structures and Systems for the 21st Century
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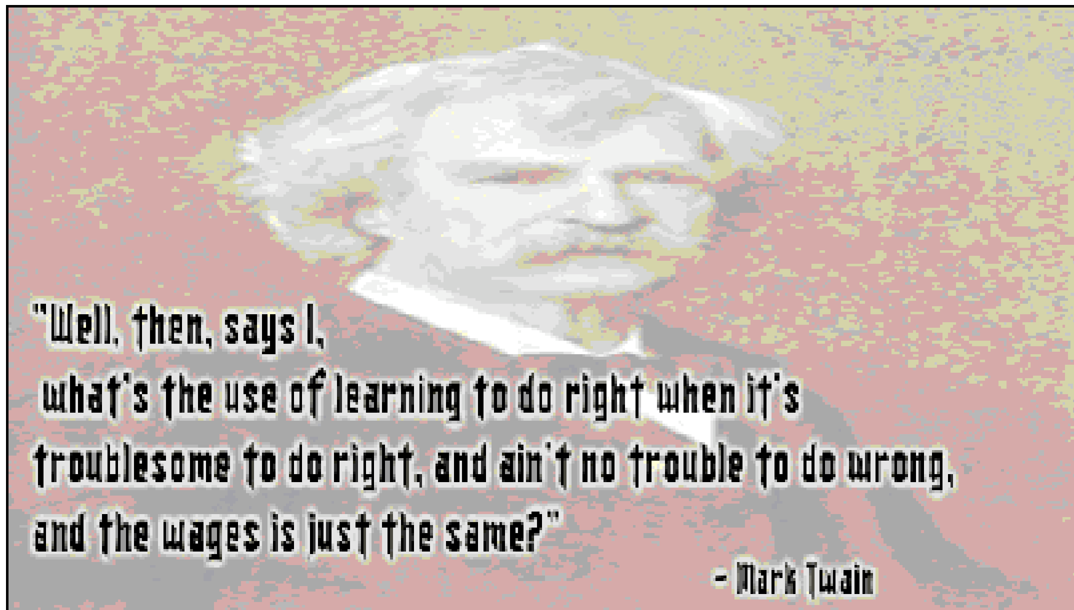
In this speech Bob Monks examines the crisis in western capitalism

* The central problem is restoring the "integrity of the corporation" – strengthening the bonds between owners, managers, governments, customers and society
* Designing a fairer incentive system for CEO's
* Harmonising the drive to increase shareholder value with societal interests.



Introduction

The conference keynote address by Robert Monks focused primarily upon executive compensation in the corporate boards of today, building upon his accompanying paper on important developments in corporate governance "Redesigning Corporate Governance Structures And Systems for the 21st Century" (copy available via Bob's personal website http://www.ragm.com/archpub/ragm/Henley101600ragm.html).

The main proposition presented and commended to the conference audience is that the most important function of the board of directors is the incentive system that is created for the Chief Executive Officer. This was justified on the basis that the energy and direction of the Corporation and most importantly - its impact on society - are determined by the incentive system with this being the most important duty of the Board. Moreover, in contemplating why a corporation exists and conducts the activities that it does, it can be argued that it does most things because the person who leads it inclines it in that direction. Why does a leader incline a corporation in a particular direction? Because the incentive structure that has been created sets it on that route.

The next question posed concerned whether, and the extent, to which Corporate Governance is in aid of better performance and better value. To consider the subject in a stochastically proven way, Monks in conjunction with Nell Minow created the following web-site http://www.corporatelibrary.com/, which includes the work of Jeanne Patterson, a Professor from

Indiana. On the site there are over 240 PhD theses and papers that attempt to show a correlation between one kind of governance pattern and value.

Perhaps the most difficult question of all to answer concerns the objective of having a well-functioning and effective Board. How can an outsider tell if a Board is well- functioning? Even as an insider within Boards, (i.e. as a Director) it is not always apparent whether a Board is well functioning or not. So the difficulty we have is trying to find metrics in evaluating board effectiveness and this is a continuing problem. It is suggested today (the first time publicly done), the effectiveness with which the Board of Directors defines incentives for the CEO can be taken as a metric for board effectiveness.

Contemporary examples of Boards who have incentive patterns with Chief Executives whereby the CE is compensated and given bonuses without any reference to the impact on the shareholders are many and numerous. Companies who have created standards for their CEOs that are outside of the market value of the stock are here. They have decided that there are things they want the corporation to do, whether or not it appears to be recognised today in the marketplace.

Compensation

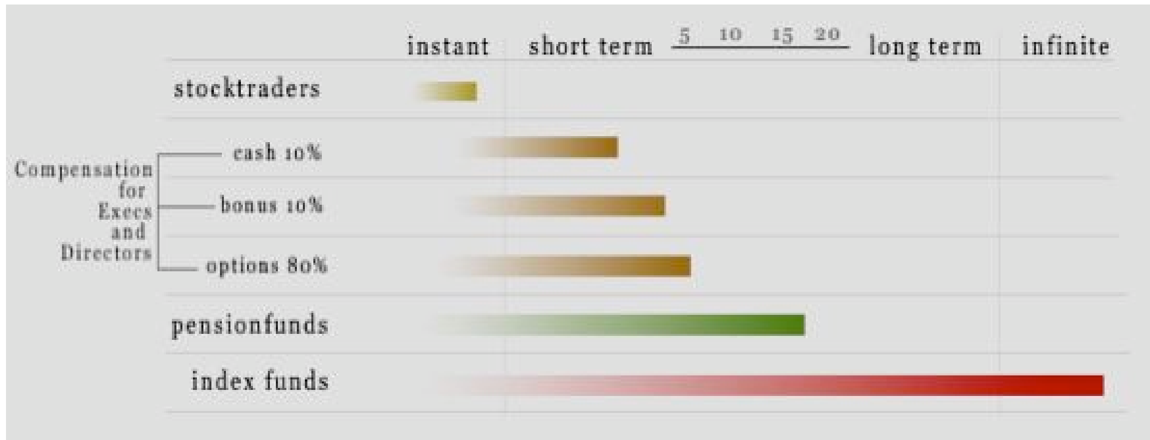
As a result, compensation in its own right and also compensation as a measure of the effectiveness of Boards will both be addressed. An illustrative example from a “The New Yorker” excerpt (August 14th 2000) emphasised that it is hard in the US certainly to find a public dialogue on the question of executive compensation.In terms of the existing structures of Boards, the following functions are outlined as classic corporate governance, where the incentive system is set by the Board:

However, in order to consider the implications of this system, a number of themes are highlighted and explored further.

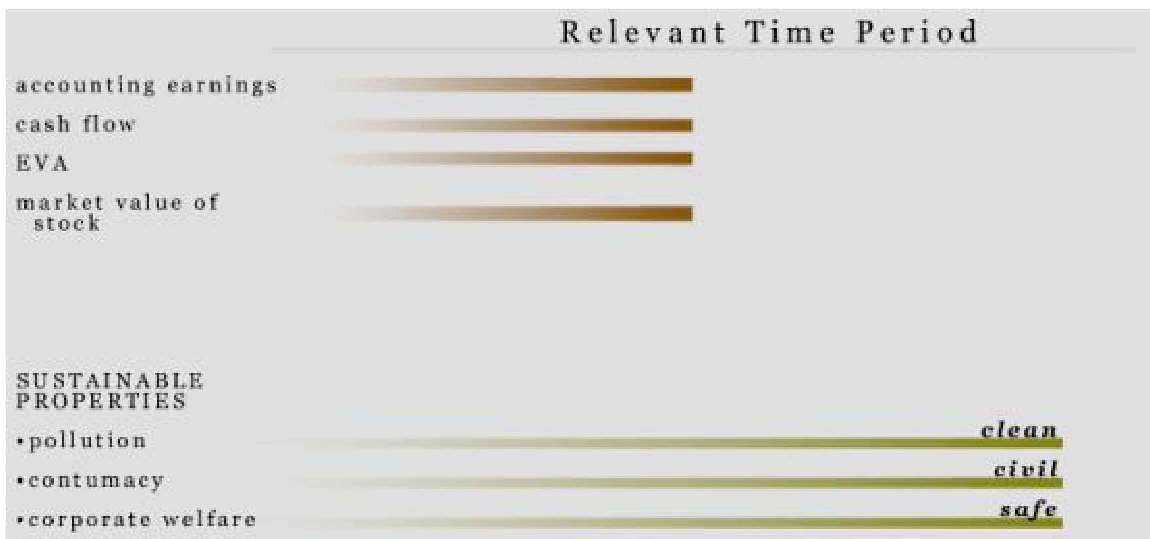
Timeframes

The first of which concerns the different periods of time that are relevant to the different actors in the corporate governance drama at different times.

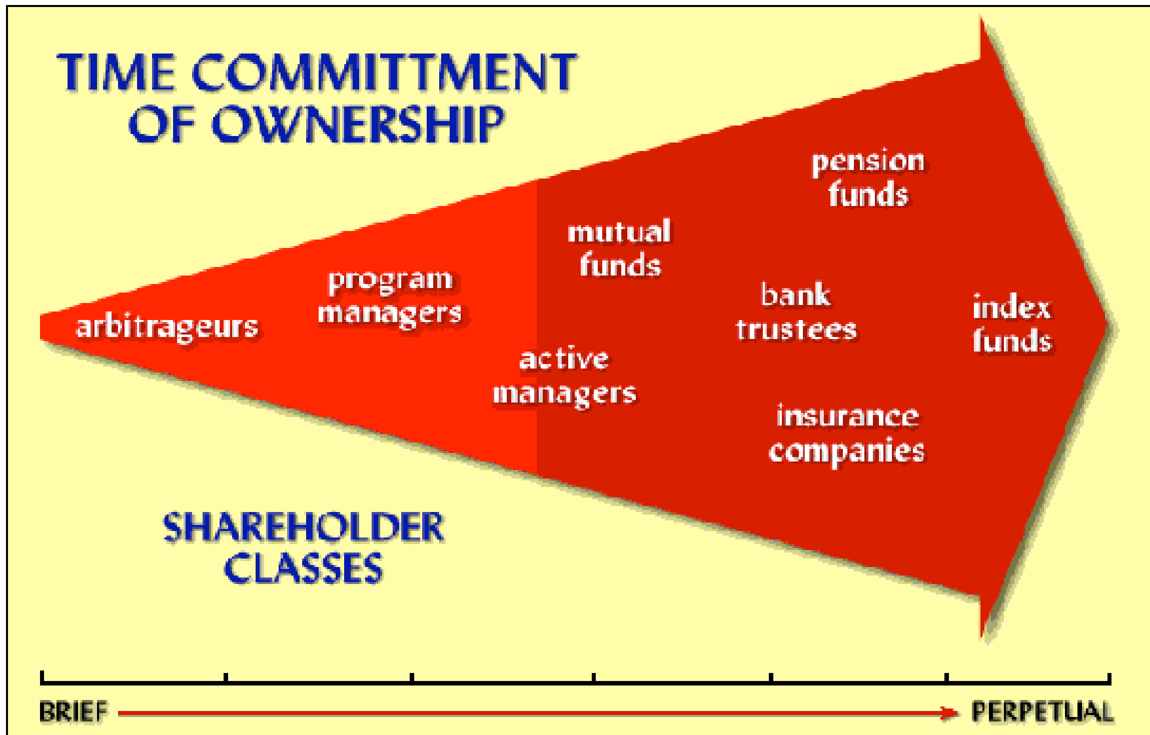
In terms of the different compensation timeframes for executives and directors, the following chart indicates the differences:



In comparison, the relevant time periods involved in traditional corporate performance reporting indicates a much shorter term tendency than accounting for "sustainable properties" inherent within considerations of the corporation’s impact on society. The chart below reflects a clear disparity as such timeframes for these factors are substantially longer than for the traditional accounting for the operations of a company.



Another dimension of the timeframe consideration concerns the different shareholders – and their respective time commitment of ownership. As the ultimate test of a corporation’s performance is the return to the owners (who are assumed to be the shareholders for argument’s sake), this becomes an important consideration



Among the class of shareholders. We have the arbitrageurs who own the stock for a nanosecond; Program Managers who have predefined criterion for selling and buying; mutual funds – annual tax considerations; active managers with a 2-3 yr. holding pattern; bank trustees owning shares for about 4 years; pension funds – 7 yr. periods; and index funds that are permanently held by definition.

When one considers the objective of a corporation is to be run for the owners – which one? Who? It appears perfectly remarkable that everyone talks so confidently about what a corporation will be run for yet no one bothers to make this fundamental point, and make a distinction in this respect.

Therefore for the student/practitioner of corporate governance, a fundamental decision to be made is who the owner(s) are. Without this, certain needs/characteristics cannot be accurately ascribed. If the requirements of the owners cannot be identified, in whose interest is the company being run? It is contended that the pension funds are the owners because they are the largest single component. Typically pension funds hold shares over a longer duration of up to 18 years. Because the beneficiaries of pension funds are approximately one-third of the entire population of the OECD countries, they serve as a good proxy for society as a whole.

Options

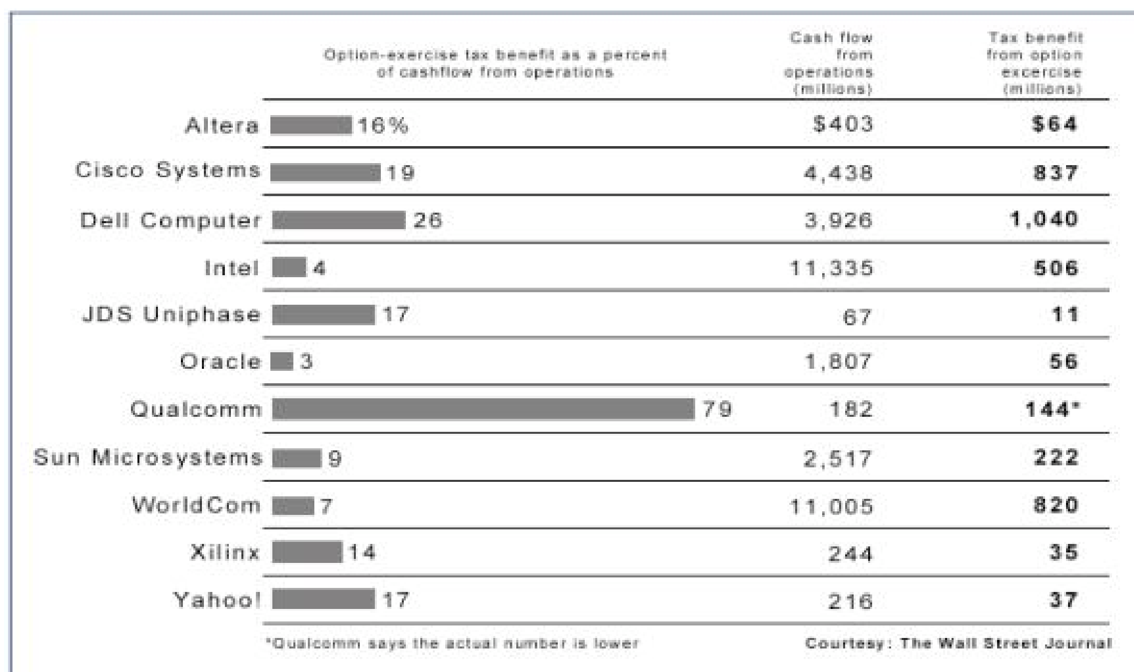
The present mode of compensation used most widely which accounts for the enrichment of principle executives of companies are options. Options are pernicious (which would come as bad news for those receiving them as well as those involved in advising on them). They are bad for a number of reasons:

(i) They purport to be something they are not. They purport to align the interests of owners with interests of managers but in fact are a one way street. When granted options and the share price actually goes down, the recipient does not actually lose any money because did not invest any.

(ii) In circumstances where a successful CEO is sought after within an industry and the share price goes down, the usual practice is to create repriced options so as to have a real incentive of putting executives into the same position as shareholders.

(iii) In the US the illusion has been further polluted by the actions of the pressure group The Business Roundtable who put effective pressure on the Standard Setting Group (of the Financial Accounting Standards Board) to the effect that if one is granted an option worth a certain amount, the Profit and Loss Statement takes no reflection of that at all. (Whereas if given a large monetary compensation that is offset against the P&L).

Options enrich you, can only go up and further, when exercised, the company takes a tax deduction on the amount between the issue price and exercise price which can also generate a lot of cash as shown in the examples on the chart below. It illustrates the impact of tax benefits from the exercise of employee stock options on operating cash flow:



	Option-exercise tax benefit as a percent of cashflow from operations	Cash flow from operations (millions)	Tax benefit from option excercise (millions)
Altera	16%	$403	**$64**
Cisco Systems	19	4,438	**837**
Dell Computer	26	3,926	**1,040**
Intel	4	11,335	**506**
JDS Uniphase	17	67	**11**
Oracle	3	1,807	**56**
Qualcomm	79	182	**144***
Sun Microsystems	9	2,517	**222**
WorldCom	7	11,005	**820**
Xilinx	14	244	**35**
Yahoo!	17	216	**37**

*Qualcomm says the actual number is lower

Courtesy: The Wall Street Journal

Options Timeframe

Options can be seen to be a pressure for the short term view. If one wishes a company to take a longer term view (i.e. 5 yr. plus) options are probably counter-productive.

In terms of the highlighting of further counter-points, the question of whether long term elements essential to sustainability are incorporated in the current stock price is raised. It has become rote wisdom that market takes into account everything but the reality is that the market is imperfect and can either not know or misinterpret. However market value is absolutely the single mode that accounts for shareholder wealth, and therefore you need market values for purposes such as knowing how much shareholders make, and for compensating executives.

The examples of Coke-Cola and Phillip Morris and the respective earnings multiples (at 36 earnings and at 8 earnings respectively) are given to illustrate the argument that the way in which corporate functioning affects society is something that the market reflects. Thus the market is in effect valuing the future cash flow as less than infinite for the tobacco industry. When trying to provide incentives for CEO or trying to evaluate the functioning of a Board, the way the Corporation impacts upon society is relative to value.

Further, a study and report by Innovest classifying industries according to the management of environment impact problems emphasises this very point. This report categorised into the best and worse companies and show that on average there was a 22% gap between the most sensitive and least sensitive to the environment within each industry. Such reports reflect the beginning of legitimacy of “soft” values, even though these are difficult to quantify, perhaps prohibitively so in the past. There is an overriding need to have incentives for corporate leadership to be based on both concepts - current value and future sustained earnings.

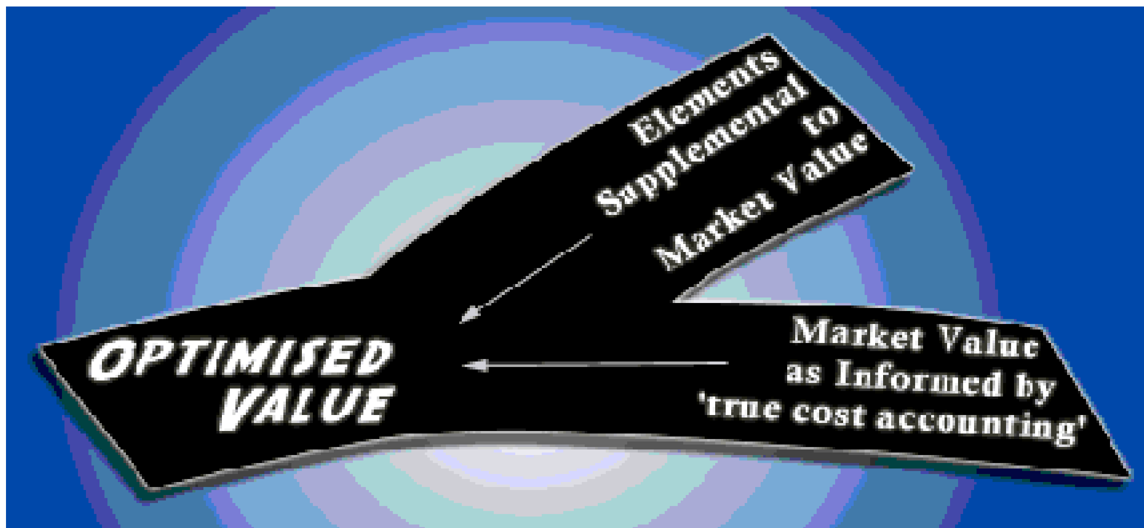
Another example is BP, where the Chief Executive’s compensation is based upon BP achieving certain emission standards by 2010, and thereby binding himself and the company to achieve that level. This was done without it being known whether the market would respond positively but an absolute stand was made. Although this has not yet shown any positive market response it may yet come.

Ford decided that a criteria that was more important than reported earnings was how it was perceived by its customers. As a result, its Compensation Committee implemented a series of metrics (i.e. dealer service, satisfaction with vehicle at different ownership intervals etc) with half of the bonuses of the entire executive branch dependent upon how they responded to these metrics.

A final example is the Shell 2000 report which illustrates the detail inherent in producing, what can be referred to as, the best articulation as to how a company goes about identifying and qualifying values which can be the basis of a compensation system for evaluating corporate conduct. The core of this is governance and values. The key performance indicators (metrics) concern perceived quality by stakeholders in their relationship with the company. There are three different levels to the indicators in terms of environmental, economic and social. Ultimately this process provides a language by which one can evaluate the company beyond the traditional accounting language. The serious problem that exists is how to take a numeric language and a written language to produce a single bottom line. Only when you have a single bottom line that reflects a conscientious inclusion of all the factors thought relevant for sustainable development does the market have the actual information necessary to properly price the security. Only when the market can properly price the security can you use the security as the appropriate mode of compensation for the executives.

It is important to appreciate the level of attention and focus necessary to identify the factors that really do have an impact on a company’s impact on society and therefore the way in which it should be valued.

In the quest for, what Peter Drucker called “optimised value” (as opposed to maximised value), two ways to get there were outlined:



(i) can be the market value if this is informed by true cost accounting (inclusion of all externalities properly quantified).

(ii) also can be achieved if you take the traditional methods of accounting and identify additional elements to be evaluated. No true “single bottom-line” exists at this moment in time despite there being extensive efforts to produce the kinds of metrics and language required. As an alternative though, use of dual accounting plus supplemental factors is required. It is only when integrated numbers are achieved, will stock values alone be suitable indicators.Conclusion In conclusion, there is a connection between compensation policy and the structure of Boards. The level of compensation has got to the point where it threatens the legitimacy of the corporation. Executive pay in the US cannot be compared with other countries, other times or the value added to the company. Within the US system, there is a perception that “CEOs pay themselves” and therefore there is a need for structural recognition for the need for change. As one proposed solution, the membership of compensation committee needs to be expanded with the addition of long-term shareholding trustees, the only people who take a long term view. Therefore a proper compensation committee (which has a difficult and tough function to perform) needs to have a shareholder on it to establish appropriate amounts.