

Built to Last:

Focusing Corporations on Long-Term Performance



A Statement by the
Research and Policy
Committee of the
Committee for Economic
Development

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The Committee for Economic Development is an independent research and policy organization of over 200 business leaders and educators. CED is non-profit, non-partisan, and non-political. Its purpose is to propose policies that bring about steady economic growth at high employment and reasonably stable prices, increased productivity and living standards, greater and more equal opportunity for every citizen, and an improved quality of life for all.

All CED policy recommendations must have the approval of trustees on the Research and Policy Committee. This committee is directed under the by-laws, which emphasize that "all research is to be thoroughly objective in character, and the approach in each instance is to be from the standpoint of the general welfare and not from that of any special political or economic group." The committee is aided by a Research Advisory Board of leading social scientists and by a small permanent professional staff.

The Research and Policy Committee does not attempt to pass judgment on any pending specific legislative

proposals; its purpose is to urge careful consideration of the objectives set forth in this statement and of the best means of accomplishing those objectives.

Each statement is preceded by extensive discussions, meetings, and exchange of memoranda. The research is undertaken by a subcommittee, assisted by advisors chosen for their competence in the field under study.

The full Research and Policy Committee participates in the drafting of recommendations. Likewise, the trustees on the drafting subcommittee vote to approve or disapprove a policy statement, and they share with the Research and Policy Committee the privilege of submitting individual comments for publication.

The recommendations presented herein are those of the trustee members of the Research and Policy Committee and the responsible subcommittee. They are not necessarily endorsed by other trustees or by non-trustee subcommittee members, advisors, contributors, staff members, or others associated with CED.

Purpose of This Statement

The committed and knowledgeable group of business, academic, and policy leaders listed on pages vi and vii including CED Trustees and invited guests, began meeting in mid-2006 to consider U.S. corporate performance. They quickly homed in on the often-observed and lamented, but never remedied, phenomenon of “short-termism”—the focus of corporate executives, and financial markets generally, on quarterly reported results to the near exclusion of enduring value. The initial deliberations sought to be broad in scope—to examine the entire financial landscape and the incentives of executives, shareholders, equity analysts, and others—because the causes and consequences of short-term thinking are present throughout financial markets, and the linkages among the various market participants seem to call for a comprehensive solution.

The subcommittee came to focus on the role directors can play in changing the culture and practices of corporations. Directors are uniquely positioned to make a difference. In addition, the composition, experience and expertise of CED’s membership enable them to contribute to a discussion about directors’ roles. As the link between shareholders and management, directors can emphasize the importance of long-term performance; their leadership can help to create corporations that are built to last.

We are under no illusion that directors by themselves can solve all problems of short-termism. Surely, shareholders and managers of pooled assets, such as hedge

funds, mutual funds, and pension funds need to be part of the solution. Nor do we think that one size will fit all; the marketplace is diverse, and each company faces its own specific circumstances. Still, though short-term considerations are often unavoidable, the growth of hedge funds and other pooled assets, among other factors, is stepping up pressure on companies to set aside long-term objectives to achieve measures of short-term performance. We are convinced, therefore, that individual corporations, and the U.S. economy as a whole, need an increased and continuing focus on enduring, long-term performance. This statement was written to encourage and help attain that necessary focus.

Acknowledgments

We are grateful for the time, efforts, and care that CED Trustees and other participants in the Subcommittee on Corporate Governance put into the development of this statement.

Special thanks go to the subcommittee chair, William H. Donaldson, chairman and CEO of Donaldson Enterprises, for his guidance and leadership. We are also indebted to Elliot Schwartz, Vice President and Director of Economic Studies at CED, and Joe Minarik, CED’s Senior Vice President and Director of Research. Thanks are also due to Daphne McCurdy, and her predecessor, Carolyn Cadei, for research assistance.

Built to Last: Focusing Corporations on Long-Term Performance

Executive Summary

Key Points

Decision making based primarily on short-term considerations damages the ability of public companies—and, therefore, of the U.S. economy—to sustain superior long-term performance.

Emphasis on quarterly earnings, compensation tied to earnings per share, shortened CEO tenures, and financial reports that fail adequately to inform about company performance impede the task of building long-term value. These phenomena are commonly known as “short-termism,” and we believe that it is the responsibility of corporate boards to use their power either to eliminate these practices or to counteract their effect.

We call on boards of directors to address these problems by putting the long-term interests of the corporate entity at the forefront of their concerns and demonstrating through their actions that those concerns trump interest in short-term price movements.

Specifically, directors can:

- Support management’s development of comprehensive strategic plans with appropriate long-term objectives, and continually assess management’s performance vis-à-vis those objectives and interim milestones.
- Structure incentive compensation plans so that a significant portion of the income of the CEO and other top executives is tied to the achievement of well articulated long-term performance objectives in line with the corporate strategy.
- Insist that corporate reporting be redesigned to include useful non-financial indicators of value, such as those proposed by the Enhanced Business Reporting Consortium, and that such measures count internally for assessment of performance.

- Eliminate quarterly guidance on earnings per share. Such guidance encourages a focus on (and sometimes a distortion of) short-term financial results and attracts short-term, speculative trading rather than long-term investing.
- Promote succession plans that emphasize growth of internal managerial talent. Doing so would help diminish reliance on costly contracts for recruited executives and may counter the pressure to achieve short-term performance.

Overview

Corporate performance in the past decade has been, in various important respects, disappointing, even though U.S. corporate profits recently have been unusually high. Our main concern is that “short-termism”—an excessive focus on a company’s quarterly reported financial results rather than on more fundamental drivers of growth and enduring value—is in fact undercutting the economic performance of some U.S.-based corporations and, therefore, of the overall U.S. economy.

By all accounts, the prominent shortfalls of ethical performance associated with Enron, WorldCom, and other companies that lost their way in the last decade was at least partly caused by pressure their managers felt to meet the financial market’s quarterly earnings expectations. Shareholders in those companies suffered direct losses, and the ensuing general loss of trust in American corporations imposed additional costs on all. Since 2002, companies and regulators have sought to restore investors’ trust, a topic CED addressed in a 2006 statement, *Private Enterprise, Public Trust: The State of Corporate America After Sarbanes-Oxley*. The focus on repairing the damage of the Enron era is necessary. It should not, however, distract business from the need also to focus on economic performance in a changing and competitive world.

The overemphasis on short-term considerations imposes high costs on shareholders and the broader economy. In corporations, these costs are manifest in: the practice of deferring investments and liquidating assets to enhance reported quarterly earnings per share, regardless of the effect on future profitability; the shortened tenure of corporate CEOs; excessive payments to corporate executives for meeting near-term and low-aspirational targets; large signing bonuses paid to incoming CEOs; and similarly generous severance and retirement benefits paid to departing CEOs. Financial markets lend their own short-term orientation through frequent trading of shares by asset managers, the consequent shorter holding periods of asset funds, and the pressures market traders and speculators bring to bear on corporate managers to produce short-term results. These practices reduce investors' returns over the long haul.

We recognize that the flexibility and adaptability of the U.S. economy are central to its long-term success. Some forms of short-term behavior, however, are not hallmarks of flexibility and prosperity, but impediments to real change and paths to long-term decline. Behavior that is focused on maximization of short-term *reported* results, rather than on investment, research, training, and other value-enhancing activities, is harmful to long-term performance.

As a general rule, we look to boards of directors as the first line of defense to protect shareholders' interests. Directors provide the link between shareholders and corporate managers. Nonetheless, the multiplicity of shareholders with different interests can sometimes leave a director uncertain about his or her fiduciary duty. **We therefore stress that the best course is to act in the long-term interests of the corporate entity.** Doing so should raise the expected value of future returns and, hence, the current share price as well. If long-term investors are being short-changed by managers' overemphasis of short-term considerations, then all shares are effectively priced below potential value and all shareholders are losing. In our view, it is up to directors to push managers back toward a longer-term (at least three to five years) view.

Although fixation on the short term is widely spread throughout business and finance, we focus our attention and recommendations on corporate directors. **Directors are the fiduciaries of shareholders' inter-**

ests and have a responsibility to counter the growth of "short-termism" by encouraging corporations to realign executive incentive compensation plans and other practices for long-term performance, to develop better and more transparent reporting of a company's performance and long-term intent, and to end the practice of quarterly earnings guidance.

Employing Corporate Governance to Promote Growth

"Corporate governance" encompasses a broad array of activities, goals, and relationships designed to serve shareholders' interests. Those interests are best served by directors who not only act as watchdogs but also use their positions to motivate management to pay greater attention to long-term performance. Earlier legal and market-based changes in corporate governance, some of which are still working their way into practice, have built the foundation for directors to play a stronger role in driving long-term performance issues.

Directors can promote long-term value creation by:

- ♦ **supporting the development of strategic plans with sound long-term objectives;**
- ♦ **linking executive compensation more closely to long-term performance; and**
- ♦ **promoting succession planning and addressing shortened CEO tenures.**

Supporting Strategic Plans with Long-Term Objectives

Acting in the shareholders' interests, the board should constructively engage with management to promote the development of long-term strategies. Such engagement should avoid the pitfall of micro-management; rather, it should focus on the process of reviewing, appraising, and enriching management's plan, and on holding management accountable for its continuing evolution and execution. To be clear, we are not suggesting that boards usurp management functions by formulating independent strategies. Our recommendation is that directors exercise their duty to ensure that management has a long-term implementation plan for a strategy, supported by risk assessment, which enhances the enduring value of the company. After reviewing and approving a strategy, the

board should stay involved by holding management accountable for that strategy and ensuring that oversight practices are in place to assess the enterprise-wide risks to the company. Directors should measure executives' performance against strategic goals.

Linking Executive Compensation to Long-Term Performance

The board is responsible for aligning the corporation's executive compensation program with its strategic plan. The setting of executive compensation incentives is a key to achieving strategic goals, since corporate executives generally will do that for which they are paid.

CED's 2006 report laid out a framework for reforming the system used to determine executive pay in U.S. corporations. Those recommendations emphasize transparency and accountability on the part of independent compensation committees and predominantly independent boards of directors. These key principles are embedded in post-Enron reforms and in newly implemented rules for disclosure of executive compensation. We expect these reforms to be effective over time and are reluctant to recommend additional regulatory measures before giving recent reforms a chance to work.

The next step is for independent compensation committees to improve the link between executive compensation and long-term performance. Performance triggers for incentive payments, when used, are often tied to short-term financial indicators such as annual earnings per share or share-price performance. Such targets encourage executives to adopt too short a time horizon and to focus too much on short-term share price and accounting measures and not enough on long-term strategic development.

To help create an effective system that links compensation to long-term performance, we recommend that directors:

- **Be vigilant in constructing pay packages that motivate executives to maximize the company's long-term economic value.** For example, compensation committees may want to spell out the long-term concerns they expect their CEO and other executives to address, such as employee retention, customer satisfaction, environmental sustainability,

development of new products or markets, adaptability to changes in public policies, or other indicators of the company's long-term health.

- **Align company executives' financial interests and incentives with the long-term health of the company and its stock price.** Although specific conditions should dictate a company's policies, in general top executives should be expected to purchase over time a substantial number of shares with their own money (not just from compensation awards) and to hold shares equal to an appropriate multiple of base salary. That is, executives should be required to act as "buy and hold" investors. Vesting and exercise periods for equity grants—options or shares—should be increased beyond existing practice and tied to multi-year performance. **For similar reasons, directors also should be required to buy and hold the company's shares.**[†]
- **Engage major shareholders in a dialogue about executive compensation programs.** Investor groups recently have begun to seek advisory votes on executive compensation, to allow shareholders to express general approval or disapproval of the company's executive compensation plan. However, an advisory vote seems a crude and unnecessary instrument for communicating about this complex topic. A simple up-or-down vote could send mixed and confusing signals. More important, we see no reason for shareholders to vote only on a company's executive compensation plan among all of the other major decisions taken by a board of directors. Because the goal of those supporting a vote is to open a dialogue about pay issues, we urge compensation committees to initiate the dialogue up front.

Encouraging Succession Planning and Addressing Shortened CEO Tenures

The shortened tenure of today's CEOs has focused those executives on short-term results and on keying compensation to such results, to ensure their wealth position over an uncertain, but likely short, tenure. The incentive to fund long-lived projects likely declines if the return on such investments comes after the end of a contract period or likely term of office. Short tenures also motivate contracts with signing bonuses and severance agreements, which have driven up executive compensation.

[†]See Memorandum Page 26

To address these issues, we recommend that directors:

- **Ensure that the company has a strong succession plan and grows managerial talent internally.** In the past 20 to 30 years, we have seen an evolution from CEOs who were nurtured and developed within a company, and who usually served at the will of the board without a contract, to a greater number of CEOs who are hired from outside and, for legitimate reasons, are employed by contract. Developing internal talent, in addition to providing direct benefits to the company, reduces pressure on compensation committees to offer incoming CEOs exorbitant contracts, complete with up-front signing bonuses and severance guarantees.
- **Consider alternatives to contracts at the CEO level. When contracts are necessary, they should be devised carefully to pursue the company's long-term goals over a realistic time frame.** As elaborated by the National Association of Corporate Directors (NACD) Blue Ribbon Commission on Executive Compensation, compensation committees should take care to determine whether a contract for a CEO is truly necessary. If the committee decides to use a contract, it should understand the potential consequences of all contract provisions. All contracts should have reasonable “sunset” provisions. Neither a resignation nor a notice of non-renewal for an employment agreement should automatically give rise to severance.

Develop More Meaningful Indicators of Corporate Value

Providers and users of financial information are increasingly vocal in complaining that the current system of accounting principles, measurement, and disclosure is more complicated and more costly than it should be. Investors also contend that the system fails to provide as much useful information as it could. One significant problem cited is that “intangibles” (such as the value of the company's brand or its relationships with employees, suppliers and customers), which often drive company performance, are not well measured, or not measured at all, under current accounting conventions.

CED addressed many of these issues in the 2006 statement (which argued that financial reports do not provide a precise measurement of corporate performance). That statement highlighted the inherently judgmental character of accounting statements, and recommended that financial reports be supplemented with non-financial indicators of value. In this statement, we focus on how such business reports could address investors' concerns about a company's sustainability and future profitability.

An ongoing effort to improve companies' reporting on the sustainability of their performance is being undertaken by the Enhanced Business Reporting Consortium (EBRC). The EBRC promotes a voluntary framework for the presentation and disclosure of “value drivers”—the elements of a company's business that are the sources of its value—and other information that many companies use in internal assessments. Public disclosure would inform investors about a company's condition and its longer-term prospects. Such disclosure may include key quantitative indicators of performance or qualitative factors such as business opportunities, risks, strategies and plans—which would help investors to assess the quality, sustainability and variability of the company's future cash flows and earnings.

Non-financial indicators, consistent with the EBR initiative, could be used within a company and in public reports without any rule changes, although companies may be reluctant to do so without assurance that it would not create additional legal liabilities. Public companies have been required to include with financial statements a narrative, known since 1980 as Management's Discussion and Analysis (MD&A), which is meant to give readers “an opportunity to look at the company through the eyes of management by providing both a short- and long-term analysis of the business of the company.” Most observers find MD&A narratives fall well short of the goal. Such narratives could be improved by following a framework like the one proposed by the EBRC.

For their internal assessments of performance, we recommend that directors encourage management to adopt reporting systems that focus attention on “value drivers” and long-term risks, such as those

proposed by the Enhanced Business Reporting framework. Directors may consider requesting reports on such metrics as part of the information provided in the board package. Companies also should voluntarily provide information derived from those systems to complement public financial reports.

Curb Quarterly Earnings Guidance

Companies should voluntarily refrain from issuing short-term guidance. The false precision of financial statements feeds the narrow “earnings-per-share” focus of managers, speculative traders, and analysts. Most observers view company forecasts of quarterly changes in earning per share, and market reliance on those forecasts, as among the primary causes of short-term behavior—possibly including aggressive accounting by some companies to “make their numbers,” or postponement of valuable long-term investments.

At present, about half of listed, public companies in the United States issue quarterly guidance on expected earnings. The role of such guidance is to communi-

cate and establish expectations about company performance. However, research studies indicate that quarterly guidance is at best a waste of resources and, more likely, a self-fulfilling exercise that attracts short-term traders. In addition, the pressure associated with quarterly earnings guidance has been cited as one of the factors fueling the boom in private equity buyouts.

In recent years, over 200 companies have discontinued earnings guidance, and the percentage of listed companies offering guidance has fallen. Companies that drop quarterly guidance have one fewer reason to manage earnings toward an earnings-per-share target and, thus, may be less likely to trade off long-term benefits for the appearance of current gains.

Though it is advisable that firms end quarterly earnings guidance, it does not mean that they should end all guidance. As discussed above, companies should provide regular guidance on long-term performance and sustainability. Such guidance should focus on company strategy, value drivers, and long-term risks.

Chapter I: Introduction

Like much of the business community, we are concerned that “short-termism”—a focus on a company’s quarterly *reported* financial results rather than on its enduring value—is undercutting the economic performance of U.S.-based corporations and, therefore, of the U.S. economy overall. This problem is pervasive in America’s executive suites and financial markets. In corporate offices, short-termism can be seen in the common practice of managing to meet the quarterly earnings expectations of “the Street,” rather than to maximize the long-term (three years and beyond) value of the corporation. In financial markets it is evident in the frequency and volume of trades executed for quick gains, in contrast to traditional buy-and-hold investing for long-term growth.

Our goal is to promote long-term corporate performance; it is not “long-termism” or its relatives, complacency and inattention. We do not value entrenched interests that have dug in for the long haul and stifled productive change. Rather, building long-term performance requires, among other things, that management and the board of directors have a strategic understanding of the dynamic factors that drive the corporation’s growth, the risks to those factors, and how to respond to changes affecting the company’s markets.

We know, of course, that short-term considerations often dominate management and board concerns, and we sympathize with those who must make difficult decisions under uncertain conditions. Some amount of short-term orientation, quarterly profit making, and attention to financial indicators is natural, unavoidable, and in some cases even desirable. Directors and managers typically must confront high levels of risk, both external and internal to the corporation, which necessarily fosters short-term thinking. Uncertainty about the future of government policies (fiscal, monetary, and regulatory), terrorism, and other external factors makes it difficult to plan for the long term, and managers must work to prosper despite such uncertainty. Time spent by corporate boards and managers on compliance

issues takes away from time available to discuss long-term strategy or look over the horizon, but that effort too is necessary. Most important, new information entering the marketplace is often a true signal of change for the long-term prospects of a company. The ability of corporate leaders to absorb new information about markets, technological change, and other economic events, make quick decisions to capitalize on such information, and manage associated risks is a strength of the U.S. economy that should not be underrated or lightly discarded. Ideally, however, decisions that address short-term issues should not sacrifice the achievement of longer-term goals.

Still, we know from experience that long-term goals have been sacrificed on occasion to short-term considerations. Sometimes those considerations cause suboptimal economic choices and lamentable underperformance, thereby harming the interests of current shareholders and other capital market participants. Other times the shortfall of performance has come from ethical lapses associated with such companies as Enron and WorldCom, where short-term financial pressures contributed to managers’ bad judgments. Shareholders in those companies suffered large direct losses, and all market participants suffered from the damage to the trust required for smooth functioning markets. As a result, all public corporations have had to make governance changes to regain investors’ trust, a topic CED addressed in a 2006 statement, *Private Enterprise, Public Trust: The State of Corporate America After Sarbanes-Oxley*.

The focus on repairing the damage of the Enron era should not distract business from the need also to focus on achieving better long-term economic performance for shareholders. As a general rule, we look to directors as the first line of defense to protect shareholders’ interests because they are the link between capital markets and corporate managers. The multiplicity of shareholders with differing interests—institutional shareholders, short-term speculators, hedge funds,

short sellers who have borrowed shares, buy-and-hold investors, and others—has appeared to leave some directors uncertain of how to exercise their fiduciary responsibilities to represent the interests of all shareholders. This report seeks to encourage directors to promote the long-term interests of the corporate entity rather than indulging speculators who care only about short-term changes in the share price.* Market forces should ensure that value-enhancing activities that can be expected to yield future benefits will be reflected in current share prices, which would satisfy the interests of virtually all shareholders.

The Causes and Consequences of Short-Termism

In principle, the economic value of a business (or its assets) is the present value of the net discounted revenue stream it produces over time. But the market value of a business at any particular moment is determined by the supply of and demand for its stock. In theory, with certain foreknowledge, the two measures of value would be the same, but real world uncertainties almost guarantee that at any specific moment economic value and market value will diverge. This phenomenon—the separation of market value from underlying economic value—seems to have become more problematic with time. A constant stream of new information—much of it of dubious worth—causes market values to fluctuate, as buyers and sellers reevaluate their positions. With the cost of trading securities lower than ever, traders, often using automated computer programs, may buy or sell based on an evaluation of each new piece of information, sometimes overreacting and causing changes in a company's share price independent of changes in the company's true condition.

Wherever one looks—whether at corporate directors and managers, shareholders, pooled-assets managers, equity analysts, or regulators—incentives and, consequently, behaviors are biased towards short-term

results. Academic research on “short-termism” shows how various intertwined factors cause well-intentioned market participants to divert attention from building for the future to focusing on the opportunities and challenges of the present.† Among these factors are:

- changes in technology and regulation that have reduced the cost of trading securities, thereby making prices more responsive to each additional disclosure, each business development, and each burst of market activity. That, in turn, sometimes causes corporate managers to act with the intent of pushing current share prices higher without regard to longer-term consequences.¹
- activities of hedge funds and other asset managers who trade large blocks of equities for short-term profits. Whether through the frequency of trading, employing a “short” strategy, or through so-called “activism” strategies, these asset managers can induce corporate managers to focus on short-term tactics at the expense of long-term strategies.²
- the growth of private equity funds, which are often seen as an antidote to short-termism because they operate on a longer time horizon, also can reinforce short-term behavior in some situations, including when the management of an “undervalued” public company feels the pressure for short-term improvement in the company's share price.
- the structure of executive compensation, which causes short-term behavior by tying performance pay to the achievement of short-term financial targets.³
- shortened tenures for CEOs (a decrease from 8.9 years in 1995 to 4.9 years in 2000), which naturally focuses their attention to short-term results.⁴ Some evidence indicates that a CEO's incentive to fund long-lived projects declines as he or she approaches retirement or the end of a contract period.⁵

* See Memorandum, page 26.

† Theoreticians have mixed opinions about whether short-termism can even exist. Some hold to an “efficient market hypothesis,” which holds that prices of shares are indeed the best estimates of real value due to the efficient pricing of the stock market. Many others have shown that the violation of certain theoretical assumptions, such as the existence of momentum trading, makes short-termism not just possible but likely.

‡ In fairness, recent research indicates that in many cases hedge fund activism has had a positive effect on the performance of a target company's share price.

- the practice of providing quarterly earnings guidance leads financial actors, both inside and outside the corporation, to focus too heavily on reported earnings per share. The perceived importance of meeting the expected earnings per share number, and the penalty imposed by market traders when reported earnings fall short, cause company managers to sacrifice future profits to boost short-term earnings.

Short-term behavior is most troubling when it diverts resources from contributing to economic growth. On balance, short-termism redistributes wealth rather than creating it. Although short-term trading and other aspects of near-sighted behavior can produce some immediate benefits, our own experiences and those of other business and investor groups that have considered this topic indicate that short-termism is overall a costly characteristic of today's financial markets, and reflects the behavior of many participants.⁶

Resources can be wastefully misallocated in several ways. For example:

- Corporate managers forgo otherwise profitable investments so that they could "hit their numbers," thereby satisfying financial market expectations but giving up the opportunity to increase long-term company value.⁷ In a survey of chief financial officers, approximately 80 percent said they would decrease discretionary spending on projects such as research to meet short-term earnings targets, and more than half said they would delay new projects even if it meant a sacrifice in value.⁸
- Corporate managers and directors spend substantial time on efforts to meet expectations of short-term results. That time instead could be spent on devising and implementing strategies that add enduring value to the company.
- Managing earnings, by shifting revenues forward and deferring costs, misleads investors and misallocates capital. When costs no longer can be deferred, the day of reckoning may cause investors to shift resources suddenly, thereby destroying economic value.
- Generous compensation of corporate managers, investment fund managers, and others for achieving financial targets that do not in fact correspond

to the creation of economic value is a direct waste of resources. Worse than the direct costs of such misallocated payments, the payments themselves cause managers to misallocate corporate resources (as noted above).

- Although financial markets have recently experienced low volatility, economists have measured a higher risk premium for assets that are subject to greater variability, and hence risk, due to frequent trading by speculators targeting short-term movements in share prices.⁹
- One measure of the cost of short-termism can be derived from the extra expenses incurred by mutual funds due to active trading. If the average mutual fund incurs an estimated 70-80 basis points of added costs from overactive trading, the resulting loss to investors would have amounted to about \$60 billion to \$70 billion in 2005 alone.¹⁰

We are concerned, too, by an infrequently noted but pernicious effect of managerial short-termism on a company's line employees and, consequently, on the company itself. As an example, managers under pressure to meet quarterly earnings goals may feel forced to lay off employees. Such layoffs affect the attitudes, decision making, motivation, and productivity of those who remain. Short-term thinking then permeates the company. Hiring practices are affected, as are training, maintenance schedules, and ultimately the quality of goods or services the company produces. A vicious cycle exacerbates problems that were once short-term in nature, and they become embedded and potentially threaten the company's long-term viability.

Recommendation to Change Board Practices

There is no single-bullet solution to the problem of short-termism. The recommendations of this report aim to identify some of the best board practices that can promote long-term corporate performance. We do not intend to mandate any particular solution to any specific business problem. Our goal is to change the framework in which directors' decisions are made to give added weight to the long-term value proposition relative to the short-term expedient. Accordingly, we suggest a number of areas in which such a change in focus would be particularly helpful.

We recognize that the problem of short-termism is not confined to the boardroom or even to the corporation. It easily can be found among asset managers who are paid on the basis of short-term results, securities analysts who feed information into the financial system, and many others whose incentives drive them to focus on the immediate, rather than long-term, results.

Nevertheless, the location of activity is inside the corporation. We, therefore, focus our recommendations on one group that can make a difference through leadership to promote long-term economic perfor-

mance: corporate directors. **In our view, directors (and boards) can best counter the growth of short-termism by demonstrating to executives and capital markets that concerns for long-term performance trump interests in short-term stock price movements. This can be accomplished by realigning executive compensation incentives for long-term performance, developing more meaningful reporting of a company's performance and long-term intent, and ending the practice of quarterly earnings guidance.** The following chapters examine these recommendations in greater detail.

Chapter II: Leverage Corporate Governance to Promote Growth

“Corporate governance” encompasses a broad array of activities, goals, and relationships. Practitioners and observers typically focus on well-functioning committee structures (for compensation, audit, and governance) composed of independent directors to ensure that management serves shareholders’ interests, capital assets are wisely deployed, and corporate managers behave ethically and legally. The reaction to recent corporate scandals has been to bolster the role of directors as “watchdog.” As essential as that role is, it should not preempt the equally important tasks of providing oversight of the corporation’s strategy for future growth and holding management accountable for its execution.¹¹

In a broad sense, shareholders’ interests are best served by corporate governance that seeks to increase the value of the corporation and, hence, the shareholder’s stake in it over the long term. This chapter examines how directors can better serve the central goal of long-term value creation by:

- supporting the development of strategic plans with sound long-term objectives;
- linking executive compensation more closely to strategic drivers of long-term performance; and
- promoting succession planning and addressing shortened CEO tenures.

The next chapter addresses the need to promote transparent reporting of the company’s financial and non-financial indicators of performance.

Supporting Strategic Plans with Long-Term Objectives

Any definition of the role of a director of a public company in the United States in the 21st century includes the essential tasks of reviewing, ratifying, and monitoring implementation of the company’s strategic plans.¹² At a minimum, the board of directors is responsible for overseeing and understanding a strategic plan developed and executed by management. As an assemblage

of presumably accomplished, wise men and women with business experience, a board can be more than a passive rubber stamp for management’s plans.

Acting in the shareholders’ interests, the board should be constructively engaged with management in promoting the development of long-term strategies.¹³ Such engagement should avoid the pitfall of micromanagement; rather, it should focus on the process of reviewing, appraising, and enriching management’s plan, and holding management accountable for its continuing evolution and execution. To be clear, we are not suggesting that boards usurp management functions by formulating independent strategies. Directors surveyed about how best to foster long-term shareholder value overwhelmingly (84 percent of responses) said that the best scenario is one where the CEO and board have joint and separate responsibilities--each working together toward common goals without losing sight of fiduciary duties.¹⁴ Directors also say they want more information about strategic concerns.

Many of the post-Enron reforms aim to empower directors to ask more questions, provide stronger oversight of management’s performance, and generally be more assertive in meeting their fiduciary duties. Directors can fulfill their duties by questioning how management’s strategy enhances the long-term value of the company, how management assesses risks, and how it will execute its strategy. We are concerned by survey findings that over half of directors do not have more than a “limited” understanding of their company’s long-term objectives.¹⁵ Certainly, we find it hard to see how a board could share responsibility for a company’s strategy—which it must—if it does not make the effort to understand and “buy into” that strategy. Of course, the precise nature of a board’s participation will depend on the specific circumstances of the company and its leadership.

After reviewing and approving a strategy, the board should stay involved by holding management account-

able for that strategy and ensuring oversight of the assessment of enterprise-wide risks to the company. Directors should work with management to understand and evaluate short- and long-term risks, and their relationship with and contribution to value creation and the overall health of the organization. Directors should measure executives' performance against strategic goals. They also should scrutinize executives' presentations in the context of long-term strategy. For example, in view of findings that executives would delay new projects to meet short-term earnings targets even if it meant a sacrifice in longer-term value, directors should ask questions about potential projects not being funded and about assets sold that may make earnings look better. Such oversight sends a message and a tone from the top that the board cares about long-term performance and disapproves of efforts to meet only short-term earnings numbers.

Ensuring the Tie Between Long-Term Performance and Executive Compensation

The board's compensation committee is responsible for aligning the corporation's executive compensation program with its strategic plan. Because executives, like most people, tend to do that for which they are paid, aligning a meaningful portion of incentive compensation to longer-term results is the single best way to motivate executives to focus on long-term performance.

The system of corporate governance in the United States has gone through significant changes over the course of the past decade. Many of these changes, such as new disclosure requirements, have yet to work their way entirely through the system. We should give them a chance to work before piling on new requirements. Compensation committees composed of independent directors should be able to structure compensation incentives to encourage superior long-term performance. Compensation committees, however, need to be diligent about aligning compensation to the company's strategic plan rather than to executive-pay consultants' benchmarks of industry comparables. Part of that process ought to include greater dialogue with major shareholders who, in broad terms, are seeking to communicate their views on the relationship between compensation and performance.

In the 2006 report, CED laid out a framework for reforming the system used to determine executive pay

Box 1. Recommendations of *Private Enterprise, Public Trust*

Compensation committees should adopt measurable, specific, and genuinely challenging goals for the performance of their businesses, and judge management on their ability to achieve them. These goals should be financial (returns on assets, investment, or equity), strategic (market share, quality improvement), operational (margins, revenues or profits), and social (such as adherence to the corporate code of conduct).

The compensation process must be run by independent compensation committees. Compensation consultants, if any, should have no business or other relationships with management (neither should the firms for which they work). They should be hired by and report to a compensation committee of the board that is autonomous from management, and that controls the terms of the consultant's engagement.

Management should have a substantial equity interest in their company. This interest should be over and above equity derived through options or grants. Barring exceptional circumstances, management should act as "buy and hold" investors.

Management should make a full, timely, and transparent disclosure of its compensation to stockholders. The compensation discussion should be presented in one place in the company's disclosure, including all forms of compensation. Disclosures should be comprehensive and easily understandable, and the SEC should consider better ways of showing the relative size of executive compensation and its trend.

Choices of forms of compensation should promote the long-term value of the firm, rather than exploit favorable accounting or tax treatment.

Severance compensation, like all other forms of executive compensation, should be reviewed carefully against criteria set by the compensation committee of the board, and the board should publicly provide full details of awards and explain publicly to shareholders the full reasoning behind the granting of such awards.

Companies should have the right to recapture bonuses awarded to top executives in error, because financial results justifying those awards later are restated adversely.

Source: CED, *Private Enterprise, Public Trust: The State of Corporate America After Sarbanes-Oxley*

in many U.S. corporations.¹⁶ The report's recommendations emphasize transparency and accountability on the part of independent compensation committees and predominantly independent boards of directors. (See Box 1.)

Recent governance reforms create the expectation that compensation committees will curtail excessive executive compensation, improve the link between pay and performance, and articulate more clearly how the various components of compensation enhance the company's performance. Over time, changes in practice should improve the linkage between pay and performance. Reform advocates have focused more on curbing unwarranted pay than on shifting incentives to long-term benchmarks. The next step is to improve the link to long-term performance.

Although the foundation is in place to strengthen the link between pay and performance, at too many companies performance triggers are tied to near-term financial indicators such as earnings per share or one-year share-price performance. These practices encourage executives to adopt too short a time horizon, and to focus more on short-term share price and accounting measures than on long-term performance. A 2006 study of Standard & Poor's 500 (S&P 500) companies by The Corporate Library showed very little correlation between the largest percentage increases in total executive compensation and long-term value creation.¹⁷

As in previous reports, we urge compensation committees composed of independent directors to construct pay packages that motivate executives to maximize the company's long-term economic value. In the 2006 report, CED stated that "compensation committees should adopt measurable, specific, and genuinely challenging goals" for the performance of their companies and their executives.¹⁸ These goals should be integrated with the company's strategic plan and the value drivers of that plan. Thus, for example, if a company's strategic plan puts great emphasis on research and development, its compensation plan ought to link rewards to success in R&D. Compensation committees may also want to spell out (in both quantitative and qualitative terms) the types of long-term concerns they expect their CEO and other executives to address, such as employee retention, customer

satisfaction, adaptability to changes in public policies, or various other appropriate indicators for evaluating the executive's contribution to the company's long-term strategy.

Compensation committees should align company executives' financial interests and incentives with the long-term health of the company and its stock price.* Inasmuch as we subscribe to the principle that CEOs and other top executives should be "at risk," boards should consider requiring them to purchase a substantial number of the company's shares over time with their own money (not just from compensation awards) and hold shares equal to a multiple of base salary, appropriate to their circumstances. In general, executives should be required to act as "buy-and-hold" investors. The specific situations of the company, its CEO, and other executives should determine, on a case-by-case basis, how compensation committees establish such targets, how the targets should be achieved, and under what circumstances a CEO would be permitted to sell stock. Under such a policy, executives will be exposed not only to their company's fortunes but also to general market conditions independent of the company's specific performance. To offset the influence of general ups and downs of the market, some companies have used market indexes or other indicators of *relative* performance to ensure to the extent possible that executives are compensated for their performance rather than on the basis of factors beyond their control. The use of indexed options, for example, is discussed below.

For similar reasons of alignment with shareholders' interests, directors also should be required to buy and hold the company's shares. Setting aside the question of how they should be compensated, directors with a significant equity stake in the company on whose board they serve will have incentives that are well matched to those of long-term investors. While compensation plans typically provide a way for a director to own an equity interest in the company, shares bought with one's own resources and held throughout one's tenure provide for stronger alignment of director incentives with shareholders' interests.

Vesting and exercise periods for executives' equity grants—options or shares—should be increased beyond existing practice and tied to multi-year performance

*† See Memorandum Page 26

hurdles. Stock option grants, until very recently, have been a favored and significant component of executive compensation.[§] Stock options were viewed by many as a means both to attract top-notch candidates and align the interests of shareholders and executives. Options can be structured in various ways. A common practice is for employment-based options to have a strike price equal to the market price when granted, have a ten-year life, and become exercisable in three years. Prior to a recent change in the accounting standard, favorable tax and accounting treatments accorded to performance-based options made the options appear to be nearly costless to the company while the process of granting them was opaque and, thus, ripe for exploitation.** A troubling result was the incentive created for executives with expiring options to attempt to boost the share price – and thus their personal fortunes – sometimes at the expense of the long-term health of the company.

Although, for reasons relating to the change in accounting treatment, options have fallen into disfavor, some companies have found ways to use options in a manner consistent with the goal of rewarding executives for superior long-term performance. For example, options can be indexed to peer groups, made exercisable at a price above the market price when granted, or tied to the achievement of performance objectives. IBM, for example, began in 2004 to use premium-priced options—with a strike price 10 percent above the market price when issued—that vest in four years.

Executives also can be required to hold shares acquired through the exercise of an option. For example, Cisco and J.P. Morgan Chase have lengthened stock option vesting periods to five years and upwards. Since 2002, J.P. Morgan Chase, like other companies recently, has required senior executives to retain 75 percent of the net shares of stock granted through equity-based awards for the entire duration of their employment with the company.¹⁹

Johnson & Johnson has a distinctive long-term incentive plan tied to five-year financial and non-financial

performance measures. It employs two separate long-term incentive programs. One, known as the “certificate of extra compensation” (CEC) plan, was established in 1947 as a commitment to “managing the business for the long term.” Awards (in the form of “performance units”) granted under the CEC plan are subject to a five-year vesting schedule and are not paid until the end of an employee’s career.²⁰

Many companies have responded to the change in the accounting and reporting of stock options by turning to grants of restricted stock (or equivalent shadow units). When granted restricted stock, the recipient does not gain the right to transfer the stock until certain conditions have been met. Typically the conditions, or vesting requirements, are time-based, but they also can be performance-based, or a combination of the two. In 2005, the value of restricted stock grants awarded by S&P 500 companies increased by 22 percent from the previous year, while the value of stock option grants awarded by these same companies decreased 17 percent.²¹

Grants of restricted stock do not by themselves change a manager’s incentives over the time horizon. The conditions attached to restricted stock grants are the key to the incentives of executives who receive them. A short vesting period would provide executives with almost the same incentive to boost stock price as they have with options. In fact, because restricted shares have an effective strike price of zero, executives gain from any positive stock price, even if it decreases from its value when granted.

Some companies have structured restricted stock grants to provide a greater incentive for long-term performance by adding performance conditions dependent on meeting specified targets such as return on invested capital, market share, total sales, pre-tax or after-tax profit levels, or cash flow.

An unusual example of practice in this area is provided by GE, which awards performance share units (PSUs) tied to multiple-year performance. GE’s CEO, Jeffrey

[§] A stock option grant provides the holder with the right to purchase a given number of shares of stock at a set price, often called the strike price, after a specified vesting period has elapsed. If the market price exceeds the strike price at the end of the vesting period, executives can profit by purchasing stock at the lower strike price and then reselling it at the market price.

** The Financial Accounting Standards Board published Statement No. 123 (revised 2004), *Share-Based Payment*. Statement 123(R) on December 16, 2004.

Immelt, is paid annually in PSUs subject to performance conditions tied to a two-year period. Long-term PSUs are tied to a five-year performance period. Thus, in 2005 Mr. Immelt was granted PSUs that will convert to GE stock only if the company's performance meets benchmarks for the 2005-2009 period. As CEO, Mr. Immelt also is required to own GE stock equal to at least six times his annual base salary.

Another award used by GE to motivate senior executives, including the CEO, is the "contingent long-term performance award," which is granted every three years and tied to specific financial performance goals. Thus, in February 2006 GE granted contingent long-term performance awards payable in 2009 only if the company achieves specified goals over the 2006-2008 period related to the growth rate of average earnings per share and average revenue, average return on capital, and cumulative cash flow from operations. In March 2006, GE paid out awards granted in 2003 for performance from 2003-2005.

Compensation committees should engage major shareholders in a dialogue on executive compensation programs. Investor groups recently have begun to press for advisory votes on executive compensation. In a January 25, 2007 letter addressed to SEC chairman Christopher Cox, representatives from 13 global institutional investors (mostly United Kingdom-based pension funds plus the State of Connecticut retirement fund) asked for support for what has been termed a "say on pay" procedure. That procedure would allow shareholders an opportunity to express general approval or disapproval of a company's executive compensation plan.²² On April 20, 2007, the U.S. House of Representatives voted to mandate advisory votes on executive compensation. Such a procedure has been in use in the UK since 2003 and in Australia since 2005. A study of FTSE 100 companies appears to support the global investors' claim that since the introduction of advisory votes companies are more frequently using longer-term performance targets in incentive compensation plans and customizing those targets to company-specific circumstances and strategic plans.²³ The investor group also observes that shareholders and proxy voting consultants seem to be focusing more on the link between pay and long-term performance.

Although we support the goal of engaging shareholders on the question of executive compensation, currently

we do not support an advisory vote on compensation policy. Specifically, we are concerned that an advisory vote in the context of U.S. corporate governance practice would send mixed and confusing signals, working against rather than for responsible engagement. It seems a crude instrument for communicating about a complex topic. How should a no vote, or even a yes vote, be interpreted? Some voters might focus on the overall compensation policy, while others might vote on the basis of specific details and outcomes. Also, how would an advisory vote, which in the U.S. context would usually come after policies had been established, affect the implementation of those policies?

We are, in addition, hesitant to recommend a U.S. policy based on limited observations of behavior in markets outside the United States. The U.K. policy is part of a broader system of corporate governance and government regulation that is far different from that of the United States. Lifting one policy out of that system and transplanting it into another may not lead to the result supporters expect. For example, the U.S. capital market recently has become concerned with the phenomenon of "empty voting," which allows shareholders to decouple voting rights from economic ownership of shares.²⁴ The potential for empty voting, or "vote buying," on the part of outside interests, or on the part of corporate insiders, creates questions about the possible manipulation of shareholder advisory votes.

More broadly, we see no reason for shareholders to vote only on a company's executive compensation plan rather than any of the other major decisions taken by a board of directors. Shareholders, for example, do not vote on a company's investment policies, which may be more significant to the long-term, or even short-term, performance of the company. The proper means for shareholders to express their opinions on executive compensation is through their votes for directors who represent them or through communication with those directors.

Because the goal of those supporting a vote is to create a dialogue about pay issues, we urge compensation committees to initiate such a dialogue up front. We also encourage U.S. companies to take steps within the U.S. system to engage long-term investors on compensation practice and its link to value creation for the long term. A good place to start would be for compensation committees to implement fully the compensa-

tion disclosure requirement called “Compensation Discussion and Analysis” (CD&A). The requirement is “principles-based,” and the SEC has made clear that CD&A should be written in plain English. The SEC has said that the purpose of the CD&A disclosure is to provide material information and perspective about the company’s executive compensation objectives.²⁵

The current year, 2007, is the first in which CD&A reports are to be filed. We know of few, if any, companies that have met investor expectations of customized and tailored disclosure. Indeed, SEC Chairman Cox has publicly complained that, relative to the SEC’s goals, submissions are unreadable, too long, and overly burdened with lawyers’ jargon.²⁶

That assessment indicates that companies have missed an opportunity to explain to shareholders, equity analysts, and the market in general how the design of compensation practices is integrated with performance goals. Making good use of CD&A and of dialogue with major shareholders could go some distance toward improving both investor relations and the link between compensation and performance.

Promoting Succession Planning and Addressing Shortened CEO Tenures

The shortened tenure of today’s CEOs has turned those executives’ attention to short-term results—and to achieving compensation for those short-term results—to ensure their wealth positions in light of uncertain, but likely short, tenures. CEOs today are three times more likely to be fired than were CEOs hired before 1985.²⁷ In the United States, the average tenure of CEOs replaced for performance reasons fell from 8.9 years in 1995 to 4.9 years in 2000, and this trend appears to be accelerating.²⁸ In 2005, a then-record 1,322 CEOs of American companies left their posts; in 2006 the number rose to 1,340.²⁹ A study of North American companies conducted by Booz Allen & Hamilton concluded that, in 2005, 35 percent of departing CEOs were forced out and approximately 44 percent left voluntarily, with the remaining departures attributable to mergers.³⁰ In any event, whether CEOs are dismissed, retired, or leave their jobs due to merger, the time they have to affect their companies has declined dramatically.

Another trend over the same period also has affected CEO performance. In the past 20 to 30 years, we have seen an evolution from CEOs who were nurtured and developed within a company, and who usually served at the will of the board without a contract, to a greater number of CEOs who are hired from outside and, for legitimate reasons, are employed by contract. In the 1980s, only 10 percent of newly hired CEOs came from outside the company, compared with nearly 20 percent in the 1990s.³¹ Similarly, fewer than 25 percent of CEOs at big companies had employment contracts forty years ago, whereas close to three fourths of CEOs of S&P 500 companies have employment contracts or severance plans today.³²

The difference between the contract and non-contract CEOs may be subtle but important. Although there have been some outstanding CEOs who have been hired from outside and worked under contract, we would like to see boards pay more attention to developing internal talent. At a minimum, doing so would reduce pressure on a compensation committee to offer an exorbitant contract to an incoming CEO, because there would be a home-grown alternative. When a CEO is hired from another company, he or she is usually compensated for the income left behind, and that person will want to be protected against the risk of being dismissed if expectations are not met quickly. Accordingly, employment contracts tend to be front-loaded with all kinds of benefits, and laden with expensive severance provisions, that do not encourage a long-term view of the company’s health. The recent experience of Home Depot, with its oversized severance payment for its departing CEO, is a case in point. By contrast, a CEO from an internal executive development and succession program already has a long-term view of the company when he or she takes office, and front-loading of benefits is not necessary.

Among the most valuable contributions directors can make to promote long-term performance is to ensure that the company has a strong succession plan and grows managerial talent internally. Under the circumstances of today’s shortened tenures of CEOs, boards may need to be much more pro-active than in the past in developing internal talent. The incentives impinging upon the short-term CEO make it less likely he or she will expend effort developing rather than

discouraging possible successors. One of the benefits of separating the positions of board chair and CEO is that it may avoid this problem. A non-executive chair generally provides a longer-term context for development of internal executive talent.

Survey research indicates that companies that do an effective job of CEO succession planning tend to be among the most admired by corporate executives.³³ Boards of “admired companies” are also more likely to receive regular updates on potential internal candidates for leadership positions. Some of these boards discuss succession issues in executive sessions, or form succession committees to work with the incumbent CEO on a long-term transition.

In line with a recommendation of the National Association of Corporate Directors (NACD) Blue Ribbon Commission on Executive Compensation, **we recommend that compensation committees consider alternatives to contracts at the CEO level.**³⁴ **When contracts are necessary, they should be devised carefully to pursue the company’s long-term goals over a realistic time frame.** As the NACD committee points out, compensation committees should consider whether a contract for a CEO is truly necessary. If it decides to use a contract, it should understand the potential consequences of all contract provisions. All contracts should have reasonable “sunset” provisions. A notice of non-renewal for an employment agreement, or a retirement, should not automatically give rise to severance.³⁵

Chapter III: Develop More Meaningful Indicators of Corporate Value

Quarterly financial reports and readers thereof typically focus too much attention on one financial indicator: earnings per share. In our 2006 statement, *Private Enterprise, Public Trust*, CED challenged the myth that financial reports provide a precise measurement of corporate performance. Our conclusion remains that **“stock analysts, the investing public, and regulators must recognize the inherently judgmental character of accounting statements and financial information. Ranges of values rather than precise numbers should be explained and understood as such. In addition, financial statements should be supplemented with non-financial indicators of value.”**³⁶

The apparent, but false, precision of financial statements feeds the narrow focus of managers, investors, directors, and analysts on the earnings-per-share number. Observers concerned about short-termism view company forecasts of quarterly changes in earnings per share, and analysts’ and shareholders’ reliance on those forecasts, as among the primary causes of short-term behavior, including the kinds of accounting manipulations practiced by Enron, WorldCom, and others to “make their numbers.”

Among other factors feeding short-term behavior is the circular relationship between companies’ provision of quarterly financial data and traders’ demand for such data. Headline numbers in a company’s press release can move the market price of its shares initially in one direction—and, later, back the other way, once analysts have time to ferret out details and footnotes in official filings. If company managers can even temporarily boost the price of their company’s shares by “spinning” results, they may be tempted to do so, thereby encouraging further speculation.³⁷

Ordinarily, though past earnings provide indications of past performance, they are insufficient for forecasting a company’s cash flows and its long-term value. For one thing, even with tighter accounting rules, companies retain sufficient discretion (for example, in estimating accruals and in accelerating revenues and defer-

ring expenses from one period to another—exactly the kind of short-term behavior we oppose) that they can hit their earnings-per-share numbers and satisfy accounting principles, but without accurately reflecting economic performance. Also, the vast majority of a company’s value—estimated by one study to be 95 percent—comes not from existing contracts reflected in financial statements but from expectations of future sales and purchase contracts.³⁸ As companies state in commonly used boilerplate language, “past performance is not necessarily indicative of future results.”

Our recommended solution is to improve the relevance, transparency, and utility of company-reported information by redesigning business reports to include useful non-financial indicators of value, such as those proposed by the Enhanced Business Reporting Consortium, and dropping the use of quarterly earnings guidance. Although these reforms may not by themselves end short-term behavior in financial markets, they will support those—both inside and outside the company—who want to take a longer-term view of corporate performance. Moreover, these reforms are useful on their own terms.

Redesigning Business Reporting

Providers and users of financial information are increasingly vocal in complaining that the current system of accounting measurement, principles, and disclosure is more complicated and more costly than it should be. Investors also contend that the system is so outmoded that it fails to provide as much useful information as it could. Disclosures mandated by government regulators are similarly problematic. One significant difficulty cited is that “intangibles” (such as the value of the company’s brand or its relationships with employees, suppliers and customers), which often drive company performance, are not well measured, or not measured at all, under current accounting conventions.³⁹ Under Generally Accepted Accounting Principles (GAAP), spending for certain types of intangibles is treated as

Box 2. Recommendations of *Private Enterprise, Public Trust* on Financial Reporting

The presentation of information in financial reports must change, and the interested public's understanding of that information must change as well.

Financial statements would be more useful if they were governed by fewer rules and displayed more of the judgment that lies behind estimated numbers. "Profits" or "revenues" or "value" are not like "temperature" or "mass" – they cannot be measured with precision. Their estimation requires judgment. The tendency to focus excessively on precise but potentially misleading accounting has been called "the brittle illusion of accounting exactitude."

The goal of financial statements must be to provide a truly fair and clear presentation of the firm. **Stock analysts, the investing public, and regulators must recognize the inherently judgmental character of accounting statements and financial information.** It must be widely understood that judgments have an enormous impact on the numbers used in financial statements. Because financial statements rely on judgments, accounting cannot continue to rely on the brittle illusion of accounting exactitude. **Ranges of values rather than precise numbers must be explained and understood as such.**

Financial statements should be supplemented with non-financial indicators of value.

Although such a system may take time to develop fully, we must get started on this road.

Auditors should not be required, or assumed, to "attest" to specific numbers, such as earnings per share. Auditors' attestations should be seen as an opinion on whether the financial statements taken as a whole are fairly stated, not whether each number is precisely correct. If their "attestations" are properly qualified, investors will be on notice of the unavoidable ambiguity in certain numbers.

Financial disclosures should be as clear and concise as possible, so as not to confuse the reader or bury unfavorable information. Financial disclosures should be written in plain English.

an expense, which lowers calculated earnings per share and acts as a disincentive to investment in worker training, R&D, and other activities that pay off only beyond the immediate quarter. Similar, if not larger, problems exist in accounting for liabilities.

Current models of accounting and other forms of corporate reporting generally have not kept pace with changes in business and the economy. The typical modern corporation is much larger and more complex than in earlier eras. It relies more on intangible assets, and it produces more services than goods. In addition, it is now possible for companies to provide much more contextual, qualitative, and non-financial information than they could in decades past, and to provide all data much more rapidly and efficiently—even if most companies have not yet invested adequately in necessary reporting systems or are reluctant to do so for various reasons, such as concerns about liability or loss of competitive advantage. CED addressed many of these issues in the 2006 report. (See Box 2.) In this report, we take the further step of examining financial and other business reporting as it concerns investors'—and their director representatives'—need to look down the road to the business' sustainability and future profitability.

Develop Better Indicators of Long-Term Performance and Sustainability

A business reporting system shapes the way decision makers—investors, directors, and managers—view and judge results. It affects the strategies they develop for allocating resources. A substantial body of recent work by individuals and organizations seeks to improve business reporting by adding information not required by the current system. Efforts to improve and enhance business reporting tend to converge around several key principles:

- + retain the strengths of the current system;
- + increase clarity, openness and transparency to users;
- + base reporting more on principles;
- + incorporate more non-financial indicators of performance;
- + incorporate information about uncertainties, and explicitly state the assumptions behind the presented estimates;

- incorporate a more meaningful discussion of both upside potential and downside risks; and
- narrow differences between U.S. and international standards.

Although this report and its recommendations focus on the role of corporate directors, many other actors share similar concerns and their work can provide context for consideration of longer-term thinking. For example: the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) are undertaking a major effort to create a common conceptual framework for an internationally converged accounting standard; FASB and IASB also have initiated a “financial statement presentation project” to establish a common, high-quality standard for the presentation of information in financial statements; the Securities and Exchange Commission (SEC) is examining ways to reduce accounting complexity; and the SEC is promoting the use of “interactive data” based on the XBRL computer standard. Although none of these efforts is specifically aimed at the promotion of a longer-term perspective, each could improve the quality, relevance, and transparency of reported information, and enhance users’ ability to make a reasonable assessment of a company’s long-term prospects. Although many believe these developments will help promote a long-term perspective, their potential to feed additional *short-termism* reemphasizes the importance of directors’ influence in ensuring that their company’s public reporting reflects a long-term framework.

The provision of information specifically relevant to a company’s future prospects is the focus of other proposals being developed by various individuals and groups. The consulting firm McKinsey and Co., for example, has proposed an approach that distinguishes between information about a company’s past performance and its future health, or long-term sustainability.⁴⁰ Corporate “health” indicators, as a supplement to performance measures, would help to assess the company’s future by focusing on the underlying economics

and how it creates value.⁴¹ Such information would include short-term, but more granular, data—about sales productivity, operating costs, and the uses of capital. Medium-term indicators might point toward the likelihood the company could maintain performance over one to five years—including information about the product pipeline, brand strength, regulatory risks, customer satisfaction, cost structure, competitive threats, and asset depreciation, among other factors. Long-term indicators would show the company’s ability to sustain competitive advantage, withstand market erosion, and expand into growth areas. These longer-term indicators would focus on risks, such as changes in technologies, consumer tastes, or threats to the company’s brand value, and probably would be qualitative in nature.

One of the most significant ongoing efforts to improve how companies report on performance is being undertaken by the Enhanced Business Reporting Consortium (EBRC). The EBRC is a U.S.-based non-profit that seeks “to improve the quality, integrity and transparency of information used for decision-making.”⁴¹ Its goal is to promote a voluntary framework for the presentation and disclosure of “value drivers”—the elements of a company’s business that are the sources of its value—and other information that would inform investors about a company’s longer-term prospects. Such disclosure may include key quantitative indicators of performance, or qualitative factors such as business opportunities, risks, strategies and plans—which would allow readers to assess the quality, sustainability and variability of the company’s future cash flows and earnings. Research shows that only 25 percent of an entity’s market value can be attributed to accounting book value, with the remaining 75 percent based on earnings performance and value drivers such as strategy, product innovation, people and customer loyalty. But less than 25 percent of the value drivers generally associated with the industry sectors surveyed are identified in formal filings.⁴²

⁴¹ McKinsey authors note the similarity between their approach and the “balanced scorecard” approach developed by Robert Kaplan and David Norton in a 1992 Harvard Business Review article, “The Balanced Scorecard: Measures that Drive Performance.”

⁴² The EBRC was founded by the American Institute of Certified Public Accountants (AICPA), Grant Thornton LLP, Microsoft Corp., and PricewaterhouseCoopers LLP. It now includes numerous other advisors and strategic partners, some of whom are members of CED’s corporate governance subcommittee that prepared this report.

Table. Enhanced Business Reporting Framework*

Level 1	Level 2
<i>Business landscape</i>	Overview Competition Customers Technological change Shareholder relations Capital availability Legal Political Regulatory
<i>Strategy</i>	Business model Organization Governance Risk management Environmental & social Business portfolio Resource allocation Product life cycle
<i>Competencies & resources</i>	Key processes Customer satisfaction People Innovation Supply chain Intellectual property Information & technology Financial assets Physical assets
<i>Performance</i>	Profitability Liquidity Operating Segment

* The Enhanced Business Reporting Framework, Public Exposure Draft, October 2005

As a detailed illustration of enhanced reporting, we reproduce above the EBR Framework Version 1.0, which is based on four categories of information:

- ♦ **Business landscape** – provides the company’s perspective on the business and economic climate as well as on other external forces that could affect the entity’s business strategy and its ability to achieve success.
- ♦ **Strategy** – communicates not only the business strategy, but also how the organization and the underlying structures support the execution of strategy.
- ♦ **Competencies and resources** – describes how the company manages available resources and competencies to execute its strategy. A principal goal of this section is identification and discussion of value drivers—the elements of a company’s business that are the sources of its value.

- **Performance** – provides insight into whether the company has produced results in line with expectations. This section explains results in relation to the preceding sections. Key performance indicators or narrative about qualitative factors presented in this section should enable stakeholders to assess the sustainability of business practices and the quality and variability of a company’s cash flows and profitability.

For their internal assessments of performance, we recommend that directors encourage management to adopt reporting systems that focus attention on “value drivers” and long-term risks, such as those proposed by the Enhanced Business Reporting Framework. Directors may consider requesting reports on such metrics as part of the information provided in the board package. Companies also should voluntarily provide information derived from those systems to complement public financial reports.

Directors are uniquely positioned to adopt a “value-driver” framework for internal deliberations, and many have. Such a framework allows the board better to monitor management’s performance by keeping informed of long-term value drivers and other key indicators. As suggested above, compensation committees also could use such a framework as a tool for evaluating and compensating management.

Ultimately, the goal should be to use a system such as the EBR Framework in both internal deliberations and public disclosures. Public reporting of non-financial indicators, consistent with the EBR initiative, could be implemented in public reports without any rule changes. Public companies are required to include with financial statements a narrative known as Management’s Discussion and Analysis (MD&A).⁴³ One of the primary principles of MD&A is to give readers “an opportunity to look at the company through the eyes of management by providing both a short and long-term analysis of the business of the company.”⁴⁴

A 2003 SEC interpretive release provided several useful suggestions, which remain valuable considerations for companies today, on how companies could improve MD&A.⁴⁵ According to the SEC’s guidance, companies are encouraged to discuss key performance indicators, including non-financial indicators of performance. With regard to overall presentation, the SEC suggested that companies: present their disclosure so that the most important information is most prominent; avoid unnecessary duplicative disclosure that can be an obstacle to identifying and understanding material concerns; and start the narrative by providing an executive-level overview that provides context for the remainder of the discussion. In short, MD&A should be written in a manner that allows for relatively easy comprehension. Companies could, for example, use the EBR Framework to enhance their MD&A narrative or the narrative of their annual reports.⁵⁵

Companies cite many reasons for not adopting a value-driver-based approach to business reporting. One reason frequently referenced by companies expresses the concern that competitors will use this information in competition against the company. Another is the desire to avoid litigation. Other often-cited barriers include: cynicism about how capital markets work; perceived benefits of playing the earnings game; reluctance to be held accountable for a broader set of performance indicators; concerns about being the first or only one to report on a key value driver; and lack of consistent and well-defined data classifications for value drivers.

Some of these justifications are easy to understand in the context of competitive markets; others are less convincing. The concern that competitors will take advantage of non-financial reporting is a legitimate concern. Companies should not give away competitive secrets. But the concern is typically exaggerated.⁴⁶ Competitors usually already know as much as they need to about each other’s strategies and operations; it is the shareholders who are in the dark. As demonstrated by existing examples, leading companies are overcoming

⁵⁵ Helpful examples of enhanced MD&A narratives are contained in publications such as the annual review of enhanced reporting published by the auditing firm PricewaterhouseCoopers (PwC), which highlights common themes emerging from narrative reporting. Available at <http://www.pwc.com/goodpractices>, 2006 *Good Practices in Corporate Reporting* (PricewaterhouseCoopers, 2005).

Deloitte Touche Tohmatsu has also published a survey, *In the Dark II*, focused on the kind of information that boards and senior management rely on and how companies measure and evaluate non-financial indicators of success. Available at http://www.deloitte.com/dtt/cda/doc/content/dtt_Audit_IntheDark033007.pdf

resistance to change and, we believe, all companies should move ahead. Certainly, it is less threatening for well-managed, high-performing companies to report more than the required minimum. Such companies gain when investors, research analysts, and other market participants better understand their markets, operations, and risks, and are better able to value the company's shares. As those companies set higher standards of reporting, markets are likely to view companies that do not voluntarily adhere to higher reporting standards as having something to hide. Thus, market pressure is likely to encourage additional reporting to overcome perceptions that a company is poorly run or poorly situated.

It would be especially helpful if FASB and the SEC, working together, could add their weight in support of financial reporting that is more transparent and more informative about the long-term value drivers and risks. Some changes may be accomplished with only some gentle encouragement from authorities. For example, the Chairman of the SEC could lend support and encouragement to enhanced business reporting and other forms of improved disclosure that shed light on long-term sustainability considerations. Over time, as experience with enhanced reporting is gained, the SEC might consider making such reporting mandatory to level the playing field and provide greater comparability of information through standardized nomenclature and definitions.

Curb Quarterly Earnings Guidance

The practice of providing earnings guidance—management's self-forecast of performance for the subsequent quarter—grew out of reforms in the early 1990s which, among other things, sought greater transparency and permitted companies to make forward-looking statements.⁴⁷ Certainly, earnings guidance can serve a useful purpose, and its goal of transparency is worthy. Supporters argue that earnings guidance reduces share volatility and boosts valuations, although in principle own-company earnings forecasts should not affect share prices.

Such forecasts might affect share prices in the short term because analysts and shareholders have come to view the ability of management to meet its own forecast as an indicator of management quality and, ultimately, the long-term prospects of the company.⁴⁸ Short-term

performance may be particularly important to analyses of newer companies with little operating history. Thus, the effect of using a company's immediate performance as an indicator of future prospects may be acute for technology-based companies in the Internet age, where network effects and the potential for "winner-take-all" results put an extraordinarily high premium on achieving exceptional results early in the life of the company.

CED recommends that companies voluntarily refrain from issuing short-term guidance. Quarterly earnings guidance is both symbol and substance of concerns over companies' lack of strategic focus on long-term performance. At present, about half of listed, public companies in the United States give quarterly guidance about expected earnings.⁴⁹ The role of such guidance is to communicate and establish expectations about company performance. Unfortunately, those expectations are focused on partial, short-term results. Consequently, the focus of management, investors, and analysts is also on partial, short-term results. And, as indicated above, managers are driven to put the goal of meeting the guidance above other, longer-term goals. In some cases, managers have made decisions, based in part on the perceived need to meet quarterly earnings expectations, that have had materially adverse effects on the company. In the case of Enron, such decisions effectively destroyed the company.

Earnings guidance is not a bad thing *per se*, but it is an example of how the law of unintended consequences can cause good ideas to have bad results. Guidance developed in the 1990s as a result of several factors. Market demand set the stage, when investors and analysts, many of whom were making their own (less informed) forecasts of company performance, clamored for companies to provide more transparency. Of particular importance was passage of the Private Securities Litigation Reform Act (PSLRA), which granted companies protection from liability when making certain forward-looking statements. Thus, companies began to offer quarterly guidance on earnings per share, to give a summary indicator of performance.

Research studies indicate that quarterly guidance is at best a waste of resources and, more likely, a self-fulfilling exercise that attracts short-term traders. A survey of directors rated missed quarterly financial results as the least important signal of the need for greater involvement.⁵⁰ Another study, which analyzed 4000

large companies between 1997 and 2004, found no evidence that guidance affected valuation multiples, improved shareholder returns, or reduced share price volatility.⁵¹ However, it found that the cost of management time and other resources devoted to providing earnings guidance was significant. Most significant is that as companies start to provide earnings guidance, their trading volume increases, and they attract more “transient investors.” The availability of information on short-term performance acts as a magnet to those who trade based on such considerations. Separately, the pressure associated with quarterly earnings guidance has been cited as one of the factors fueling the boom in private equity buyouts.⁵²

To an extent, market pressure to provide earnings guidance may be receding, as many participants already find the practice to have more costs than benefits. In recent years, over 200 companies have discontinued earnings guidance, and the percentage of listed companies offering guidance has fallen.⁵³ Companies that drop quarterly guidance have one fewer reason to manage earnings to hit an earnings-per-share target and, thus,

may be less likely to sacrifice long-term benefits for the appearance of current gains. A membership survey taken by the CFA Institute, a prominent organization of investment analysts, showed that three-quarters of respondents preferred that companies move away from quarterly earnings guidance and towards providing more information on a company’s long-term prospects. A key obstacle to change is the close link between short-term performance and incentive pay for company managers, fund managers, and analysts. (The relationship between performance pay and short-term results was examined in the previous chapter.)

The downsides of quarterly earnings guidance, however, should not dictate that companies end all guidance. As discussed above, companies should provide regular guidance on long-term performance and sustainability. Such guidance should focus on company strategy, value drivers, and long-term risks. Less focus on quarterly earnings per share and more focus on long-term variables would give analysts and investors more useful information about a company’s prospects.

Memoranda of Comment, Reservation or Dissent

Page 6, and pages 24-25, Roderick M. Hills, with which Deborah Bailey, Patrick Gross, Harold Williams, and Linda Wilson have asked to be associated.

I am pleased to approve the Corporate Governance Report but I disagree with two points made in it:

- “[B]oards should consider requiring . . . [CEO’s] to purchase a substantial number of the company’s shares over time with their own money (not just from compensation awards)”.
- “Directors also should be required to buy and hold the company’s shares.”

I see no justification for such blanket requirements. In some circumstances, requiring a newly recruited CEO to purchase stock may make sense. It can demonstrate that he believes in the future of the company and is not simply looking for a paycheck. In other cases the company may be in distress. It may seem to the board more than sufficient that the newly recruited CEO is willing to risk his or her reputation. When a long-time employee is promoted to CEO, why should he be required to tie up more of his capital?

Also, boards must make allowance for a CEO to sell stock from time to time to enjoy the fruits of years of labor. So long as a CEO holds significant equity, whether some is bought with personal funds or some is sold on occasion should not be determined by fiat.

There is little reasonable justification to require a new director to purchase stock from personal funds. What kind of message is sent by a forced purchase? It shows no real confidence in the company, and will preclude many people from joining boards. It is sufficient to make a significant part of a director’s compensation in the form of equity, and to require that such equity be held for so long as the director continues to serve.

Page 8, Donald K. Peterson, with which Harold Williams and Linda Wilson have asked to be associated.

On the fiduciary responsibility of directors.

Under some corporate pension plans, directors of the board or their delegates are fiduciaries of the plan. As fiduciaries of the corporation’s pension plan, directors have a responsibility to act in the interest of plan participants, with the purpose of providing benefits to them.

One of a fiduciary’s responsibilities is to act prudently with respect to the assets and liabilities of the plan. Because the liabilities of a pension plan are long-term, it makes sense for the plan’s assets to be invested for the long term, aside from amounts needed to meet current and near-term obligations. By this reasoning, it appears counterproductive for plan fiduciaries to support investment in asset classes that have a speculative or short-term focus. Yet, pension plans have supplied capital for some hedge funds and investment funds that have contributed to short-termism.

This report does not specifically make recommendations to managers of pension funds and others who hold shares of corporate stock. Nevertheless, directors, who play many roles within the corporate system, should be mindful of the inherent inconsistency between countering short-termism in deliberations of corporate strategy, executive pay, and other matters, while contributing to the problem through pension fund investments.

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- New Opportunities for Older Workers (1999)
- Investing in the People's Business: A Business Proposal for Campaign Finance Reform (1999)
- The Employer's Role in Linking School and Work (1998)
- Employer Roles in Linking School and Work: Lessons from Four Urban Communities (1998)
- America's Basic Research: Prosperity Through Discovery (1998)
- Modernizing Government Regulation: The Need For Action (1998)
- U.S. Economic Policy Toward The Asia-Pacific Region (1997)
- Connecting Inner-City Youth To The World of Work (1997)
- Fixing Social Security (1997)
- Growth With Opportunity (1997)

CED Counterpart Organizations

Close relations exist between the Committee for Economic Development and independent, nonpolitical research organizations in other countries. Such counterpart groups are composed of business executives and scholars and have objectives similar to those of CED, which they pursue by similarly objective methods. CED cooperates with these organizations on research and study projects of common interest to the various countries concerned. This program has resulted in a number of joint policy statements involving such international matters as energy, assistance to developing countries, and the reduction of nontariff barriers to trade.

CE	Circulo de Empresarios Madrid, Spain
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CEAL	Consejo Empresario de America Latina Buenos Aires, Argentina
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CEDA	Committee for Economic Development of Australia Sydney, Australia
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CIRD	China Institute for Reform and Development Hainan, People's Republic of China
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EVA	Centre for Finnish Business and Policy Studies Helsinki, Finland
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FAE	Forum de Administradores de Empresas Lisbon, Portugal
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IDEP	Institut de l'Entreprise Paris, France
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IW	Institut der deutschen Wirtschaft Koeln Cologne, Germany
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経済同友会	Keizai Doyukai Tokyo, Japan
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SMO	Stichting Maatschappij en Onderneming The Netherlands
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SNS	Studieförbundet Näringsliv och Samhälle Stockholm, Sweden
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