

SKBA CAPITAL MANAGEMENT

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Open Letter To Corporate Directors: Want Better Corporate Governance? Change the Structure of Your Incentives:

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It must be tough being the CEO or CFO these days. The spectacular malfeasance at Enron Corp. and Worldcom Inc. among others, has besmirched the reputations of even honest managers. The environment has become tough for directors, as well. Corporate America needs knowledgeable, honorable, and responsible directors and management. However they choose to modify the corporate governance at their companies, they ought to begin the process sooner rather than later, or more Sarbanes-Oxley type reforms will fill the void.

Some criticism heaped on corporate management is deserved. Shareholders were defrauded at some companies. Even at others where there was no fraud, compensation reached egregious levels; pay at the senior ranks often seemed disconnected from performance. What a CEO actually earns, however, is not really the critical issue. If an "overpaid" management team delivered a superior level of wealth building, shareholders would be overjoyed to pay it.

This appeared to have happened in the second half of the 1990s. Did many management teams actually deliver non-employee wealth creation on any sustained basis? No. In fact, managements appeared to have enhanced their own wealth at the expense of stockholders and stakeholders as well.

What constitutes the ephemeral concept of "good management" that ought to be rewarded? How should management and employees be rewarded in ways that promote the building of shareholder wealth, as well as the success of stakeholders such as non-management employees and the communities in which a company operates?

Even though most management teams are honest, honorable, and ethical, the problem is no matter what one believes about someone's altruistic motives, managers tend to do what they are financially incented to do. Incentives need to be structured to align motivations with shareholders.

So it is in shareholders' interests for the board of directors to get it right. Here are a few suggestions for boards:

Require each member of the senior management team to own stock, at least five times his or her annual base compensation, not connected to any options program. There's nothing like having skin in the game to align the interest of management with shareholders. Non-qualified options do not do this as well as direct stock ownership. They certainly motivate management to get the stock price up for a sufficiently long period to enable them to cash in these options and earn a bonus of their own timing, but it doesn't turn agents (management) into owners (shareholders) in a way that motivates them to build sustainable wealth in the company.

It is an interesting question about what level of ownership by senior management and directors maximizes the benefit to non-employee shareholders. It is mostly likely between 2% and 20% of outstanding shares. Below 2%, there is not enough personal investment at risk such that a management's wealth would be hurt by management's own mistakes and failures, and above 20%, management has sufficient control to run the company in their own interest, whether or not this is aligned with non-insider shareholders. Caveat emptor applies to those willing to buy into companies dominated by insiders.

View the auditor as the company's friendly adversary. This is why shareholders vote in favor of resolutions that require the audit committee to consist entirely of non-affiliated directors. The review and advice from auditors is critical to helping the board meet its fiduciary duty. With the audit portion of an accounting firm's business being more of a loss leader for the management consulting side of these firms, no wonder auditors have progressively relied more on the soundness of management control systems rather than on detailed testing of accounts. This is why a board should also decline to engage in contracts with the management consulting side of the auditor's firm.

Create a compliance officer program that does not report to line management. Compliance officers, whether involved in financial or operational compliance (e.g. insuring plants are following company environmental policies or governmental regulations), should not report to line management. If your boss's bonus is dependent upon business unit profitability,

how can you possibly review this objectively if, as the person in charge of compliance, you report to him or her? A company needs to install a separate reporting structure for such persons or their effectiveness in protecting the company and shareholders is diminished.

Never base cash or restricted stock bonuses for upper level management on one-year earnings per share or pretax income targets. Management has great discretion to defer an expense here or accelerate revenue recognition there such that the earnings per share threshold that is established for the determination of bonuses is met. All such incentive plans, whether based on earnings per share growth targets or economic value added, need to be set up on the basis of at least rolling three-year results, not annual results. Three years is just long enough for a successful performance in any one year to boost management bonuses, but no one is motivated to goose the results of one year at the expense of the next. Furthermore, all non-extraordinary income and expenses (as defined by FASB) should be included in these measures. How are shareholders benefited, or employees for that matter, if all manner of recurring “non-recurring” restructuring charges are excluded from bonus calculations? If today’s income is taken away by tomorrow’s restructuring charge (and the accompanying employee layoffs), how does this create a sustained business? Management must be held accountable for business growth decisions that turn sour.

Award and pay a meaningful part of sales commissions at the time of the receipt of cash payment, not just on the order, delivery or even customer acceptance. Not only will your sales rep be properly motivated to make realistic promises about product performance or delivery schedules, but the person will have less incentive to generate inappropriate revenue recognition and will reduce the opportunity for products to be sent to an empty warehouse based on fictitious invoices.

Expense stock options compensation as is discussed in the FASB’S recent proposal. Everyone can now figure out what the real cost of options is from your financial statement footnotes; so you might as well just start expensing them. Options have and still create a huge contingent liability for companies as the large amount of cash flow necessary to reduce the dilution of option shares at their exercise is not available for use in investments for growth, dividends for shareholders, or net stock repurchases to shrink capitalization if there are no better uses. They are not costless to companies

and without properly expensing this loss of discretionary cash flow, earnings are overstated. Senior management holders of options have a natural incentive to boost earnings and to retain cash flow to artificially and unsustainably boost their stock valuations. There is nothing wrong with using stock options as an incentive if they are properly expensed. Stock grants, as Microsoft has recently decided to offer, are far better in aligning employee interests with those of non-employee shareholders.

Offer earnings forecasts to investors that reflect a wide range of possible outcomes. Offering a narrow estimate range contributes to volatility of the stock’s price as consensus expectations on Wall Street congregate around management’s guidance. This makes both disappointments and positive surprises more likely, and we all know that these days a 2-cent earnings shortfall relative to consensus expectations can lead to a 40% decline in a company’s stock price – in one day! Who is well served by this model? No one. The company’s guidance to Wall Street should widen the range of expectations such that the company offers a range of internal scenarios for the impact of the economy, industry, and products on the earnings performance. The board will be rewarded with much greater stock price stability if the earnings expectation range is widened.

Pay dividends. Surely there are companies for which their growth investment opportunities exceed their cash flow generation, and the payment of a dividend would be inappropriate. So this is not a suggestion that non-payers should be penalized for retaining all of their cash flow. These days, however, the ability to pay and sustain dividends cuts through the questions about the quality of earnings, and there’s no longer any relative tax penalty for paying dividends. There is no greater proof statement that the board and senior management are managing the business at least reasonably well than to pay or raise the dividend as the company’s earning power increases and maintain it during business downturns.

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