

RUNNING HEAD: THEFT OF SHAREHOLDER WEALTH

THEFT OF SHAREHOLDER WEALTH: THE FIDUCIARY'S
RESPONSIBILITY TO HUMAN CAPITAL INVESTMENT

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THESIS: THEFT OF SHAREHOLDER WEALTH: THE FIDUCIARY'S RESPONSIBILITY TO HUMAN CAPITAL INVESTMENT

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Abstract

In the United States of America, corporations are the foundation of our entire national economy. As the power and influence of the corporations have grown, so have the performance expectations of its shareholders. Shareholders have begun using their power to make their message very clear to their corporations: they expect great wealth from their investment. This manuscript focuses on the human capital of the corporation. Its underlying premise is that barriers that are preventing the enforcement of fiduciary responsibility of agents of a corporation to return maximal shareholder wealth through investment in human capital must be identified and addressed.

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THEFT OF SHAREHOLDER WEALTH: THE FIDUCIARY'S RESPONSIBILITY TO HUMAN CAPITAL INVESTMENT

CHAPTER 1 - Introduction

In the United States of America, a capitalist society, corporations are the foundation of our entire national economy. With the power and influence of their revenue, labor force, and advertising and marketing activities, corporations dominate every aspect of American lives. At the foundation of the corporate entity lay its owners, its shareholders. As the power and influence of the corporations have grown, so have the performance expectations of its shareholders. Shareholders have begun using their power of capitalization to make their message very clear to their corporations: they expect great wealth from their investment.

They have reason to be testing the limits of their strength. Current news is filled with corporate scandals highlighting excessive executive greed, the lack of proper corporate governance and transparency, and a total disregard of society's ethics, morals, and laws. This publicity is typically centered on the theft of money, the misappropriation of funds for a particular executive's personal gain, creative accounting, or the breaking of banking, insurance, or other regulatory laws, etc. These circumstances have occasionally resulted in jail time for executives, but more frequently they have resulted in fines and penalties assessed to the corporation, thereby incurring a loss of net profit, and affectively billing the shareholders for the costs through the reduction of shareholders earnings.

In addition to these direct attacks on the shareholders, another, indirect, abuse of its investors by corporations is not maximizing shareholder wealth with the given resources available to the corporation. There are ways and means that have been often overlooked, as they are perceived as difficult to measure concretely, and are therefore

frequently undervalued by management, but in today's economy corporations must work on every endeavor available to return to the shareholder maximal wealth. One such method that is already present today, and has been present since the invention of business, is investment in human capital.

Human capital is comprised of the corporate asset that keeps the corporation productive, specifically, its employees. Regardless of how much machinery a corporation possesses, or in what industry a corporation is conducting its business, people are what make the difference. Human capital, also referred to herein as either human resources or human resources management, is the bona fide engine of any corporation. It is with human capital that a corporation will grow and thrive, or stumble and fail. In the Pope's 1991 *Centesimus Annus*, he said: "Whereas at one time the decisive factor of production was the land, and later the capital . . . today the decisive factor is increasingly man himself; that is, his knowledge (Lebens 2002)." This is not a philosophy that businesses leaders have rushed to embrace.

The legal agents of a corporation, whether the Board of Directors, executive management, middle management, or front line supervisors, all have an impact on shareholder wealth through their fiduciary responsibility. Enforcement of these fiduciary responsibilities, however, has not been frequently tested in the courts when pertaining to intangible assets, which is inclusive of, among other elements, human capital. Regardless, consultants, researchers, and scholars have assessed there are indeed ways and means of increasing the value of human capital, subsequently raising the level of wealth for the shareholders, therefore concluding that these agents *must* address this issue immediately as part of their fiduciary duties and obligation to the shareholders.

This manuscript focuses on the human capital of the corporation. Its underlying premise is that barriers that are preventing the enforcement of fiduciary responsibility of agents of a corporation to return maximal shareholder wealth through investment in human capital must be identified and addressed. The objective of this manuscript is to shed light upon an area of business, focusing on the corporate entity, that often goes overlooked and under valued. Human capital is a source of great wealth and prosperity and is paramount in today's global economy.

The focus of industry has changed significantly over time; scholars are referring to our current state as the *knowledge economy*, the *information age*, or the *creative economy*. Along with this change in industry, a shift has been made in which the focus has moved from *tangible*, or structural capital, to *intangible*, or intellectual capital. Intellectual capital is commonly divided into human capital, intellectual assets (including intellectual property), and goodwill (Kurz 2000). "Intellectual capital," is the most common term for intangibles because it embraces more than just the people. Another accepted division of intellectual capital is customer and market-related capital, such as brands, image, contracts, loyalty, and market share; infrastructure capital, which includes systems, patents, culture, and knowledge; human capital, such as expertise, motivation, commitment, teamwork, and leadership (Mayo 1999). Furthermore, scholars, on occasion, have broken down the composition of the intangibles as being comprised of technology-based assets, customer-based intangibles, market-based assets, workforce-based assets (human capital), contract-based assets, organizational-based assets, and statutory-based (intellectual property) assets (Harvard Management Update 2001). The interest in these intangible capabilities, in whatever permutation they are defined, is due

to an “intensified business competition” and “advent of information technologies (Lev 2001, page 9).”

The American corporation, without a focus on intangible assets, especially human capital, has the potential to lose its lead in the global economy as foreign corporations already begin to invest in their own human capital, while simultaneously extracting from the American corporation the necessary skills, talent, and knowledge of America’s own human capital. In addition, with an aging population, the American workforce is already becoming an ‘employee market’ and those corporations valuing human capital the most are those that will successfully recruit and retain the most productive employees and win in both maximal shareholder wealth and growth in the global economy.

Purpose

The purpose of the study is to address a number of issues occurring in the American economy. First, the aging of the American workforce will result in an increase in global labor competition. Because there will soon be fewer employees, every employee will be required to produce more than ever before in order to meet an ever increasing consumer demand and corporations will need to improve its recruitment and retention policies. Second, there is an increasing emphasis on intangible assets, such as human capital, because it has been recognized and proven that intangible assets carry the bulk of corporate value, but yet still goes unattended. Third, the shift to the knowledge age and the effect upon business must soon be recognized. With this shift, large amounts of tangible assets will simply not allow a corporation to grow or produce maximal shareholder wealth, resulting in an increase of focus on the corporation’s intangible assets. Fourth, investor confidence in this country is dwindling, due to the recent spate of

high profile cases of embezzlement, shoddy accounting, insufficient corporate governance, and a lack of shareholder intervention; it must be restored. Finally, even very recently, there was a distinct lack of quantifiable data available on intangible assets, especially human capital. As a direct result of scholarly endeavors, new research and studies are available providing the data necessary so that corporations can place due emphasis on human capital.

Delimitations

This manuscript has been researched and drafted focusing only on American securities-issuing private corporations, whether private or held. This classification of corporation is the simplest to study and affects the most number of shareholders, while simultaneously being restricted by the highest number of governmental regulations. This manuscript does not recommend and does not intend to assess what methodologies are best when conducting a valuation on intangible assets or what strategy is best in order to increase overall value in human capital. Because of the legal subject matter, it should not be construed that this is the foundation for any legal argument and, furthermore, as this is a manuscript outlining matters pertaining to general business, that case law and other professional legal viewpoints and definition are presented without the aid of a legal advisor. *Legal Terminology*, located in the Appendix, contains a summary of necessary legal definitions for reference only. A number of points discussed are based upon the opinions and theories of scholars. In relation to scholarly theories, the position of this manuscript is that shareholder theory prevails over stakeholder theory for discussion purposes only. Other theories will be presented, but the reader needs to understand that these are theory and one may not necessarily agree with the position taken, and that this

manuscript's recommendation and conclusion may change with the acceptance of another theory not presented herein. Also, throughout the manuscript, 'intangibles,' 'knowledge assets,' and 'intellectual capital' may be interchangeable in terminology. As Baruch Lev indicates, the term *intangible* is commonly used by accountants, *knowledge assets* is favored by economists, and management and legal literature prefers the term *intellectual capital* (Lev 2001, page 5).

Research and Organization

The research and studies for this manuscript have come from scholarly journals, papers and articles determined to be authored by experts in the field, and books based upon proven methodologies and substantiated by either practice or extensive research. This manuscript is organized in such a way that it, first, outlines the evolution and factors related to the agent's fiduciary duty to maximize shareholder wealth through human capital investment; second, that data will be presented substantiating existence of the premise; and third, that the manuscript shall outline the significance of the existence of the premise. Finally, after considering the research and studies provided and outlined herein, recommendations and conclusions addressing the agent's fiduciary duty to maximize shareholder wealth through human capital investment will be presented.

CHAPTER 2 – Evolution Of The Theft Of Shareholder Wealth

Many factors have contributed to the theft of shareholder wealth. First, shareholders have not taken an active role in their investment other than monitoring stock prices or focusing on the short-term gain. Second, little has been accomplished in aligning legal corporate agents with shareholder interests. Third, little is actually in place, pertaining to regulatory means, to pursued corporations from pursuing shareholder interests. Fourth, management has not fully understood the importance of intangible assets and their value on the corporations. Fifth, management of the corporation pursues interests other than that of the shareholder wealth. Finally, sixth, corporations have not recognized that human capital is their greatest asset.

The Quest for the Shareholder Voice

The utility function of different classes of stakeholders varies, and the degree of alignment of interests with those agents in the firm who control the major decisions is different (Ingley 2004). This gives rise to conflicts among stakeholders and these “incentive” conflicts have become known as agency (principal-agent) problems (Ingley 2004). Much of the attention concerning agency problems has focused on the shareholder-manager relationship in a firm (Ingley 2004).

Unhindered, each class of stakeholders will pursue its own interests, which may be at the expense of other stakeholders (Ingley 2004). Agency problems are costly because they detract from the efficient operation of an enterprise (Ingley 2004). This class of agency problem is known as *managerial agency* or *managerialism* (Ingley 2004).

It has highlighted the dichotomous views held with regard to agency theory. On the one hand, managerialist scholars have

considered management's essentially autonomous exercise of power to be legitimate and efficient. By contrast, anti-managerialists take issue with the fact that inside management has had little accountability to owners; that senior managers have effectively controlled the board of directors; and that the financial communication has treated management with almost unquestioning deference (Ingley 2004).

Alfred Chandler points out that the history of capitalism has essentially been the history of managerial rather than shareholder capitalism where, for much of the last century, companies were run by professional managers (Ingley 2004). The proposed correction to the failings of this system is that shareholders be given sufficient power and incentive under revised regulation to raise governance issues (Ingley 2004). It also urged the clarification of existing laws to assure shareholders and, possibly, the participants of employee benefit plans, that they have access to the courts for effective remedy (Ingley 2004).

Because of this history of managerial autonomy, current corporate law discourages shareholders from mounting opposition campaigns (Joo 2003). The premise of agency theory is that agents are

self-interested, risk averse, rational actors, who always attempt to exert less effort, due to moral hazards, and as a result project higher capabilities and skills than they actually have. Agency Theory is split into two camps. The first camp, positivist research, has "focused on identifying situations in which the principal and agent are likely to have conflicting goals and

then describing the governance mechanisms that limit the agent's self-serving behavior." Positivist agency research is almost exclusively concerned with the goal conflicts between owners and managers. Along the positivist line, Jensen and Meckling examined how equity ownership by management helps align goals of the managers with those of owners; Fama examined the role of capital and labor markets in controlling the behavior of managers. The second camp, principal-agent research, believes in a general theory of principal-agent relationship applicable to employer-employee, lawyer-client, buyer-supplier relationships. According to Eisenhardt, the "positivist theory identifies various contract alternatives, and principal-agent theory indicates which contract is the most efficient under varying levels of outcome uncertainty, risk aversion, information, and other variables." Agency theory has grown beyond its original positivist domain and has been used by principal-agent researchers in a number of disciplines to study issues that arise from agency-like relationships, for example, superior-subordinate relationships (Ekanayake 2004).

Two clear types of principal-agent relationships are present. First, between the firm's owners or shareholders (the principals) and the top management (the agent). Second, between the firm's top management group acting as the principal and the divisional managers, who manage the decentralized units, as the agents. Some research has extended the conceptualization of this second type of principal-agent relationships to

encompass superior-subordinate, employer-employee, manager-worker relationships. Agency theory's implications for management control are wide ranging. First, it implies that an agent's self-interested behavior can be monitored by information systems. Secondly, agency theory views control system aspects of compensation and incentive schemes as tools for aligning agent's motives with organizational goals. Third, agency theory brings into focus uncertainty and risk considerations that need attention in devising control systems (Ekanayake 2004).

When an agent of the corporation, acting in his capacity as such, undertakes an action that causes damage to a third party, the law establishes a regime of "dual liability" in which both the corporation as a legal entity and its culpable agents, be it directors, managers, or workers, share potential liability for the offences that corporate activities inflict on third parties, so either or both of them can be held liable and be required to pay remedy (Urutiaga 2004). Two primary responsibilities are present: the duty of care and the duty of loyalty

The three ingredients that comprise this breach of the duty of care are damage, negligence, or failure to exert due care and causality. The duty of care has a double function. *Ex-ante* has a preventive function, giving the director the necessary incentives to exercise the necessary level of care so as to reduce the probability of damage to the corporation. *Ex-post* has a compensatory function, compensating the shareholders in case the damage occurs (Urutiaga 2004). Under the business judgment rule (Urutiaga 2004), the director is assumed to have fulfilled his duty of care if in making a business judgment in

good faith he, one, is not an interested part, two, is reasonably well informed, and, three, rationally believes that the business judgment is in the best interest of the corporation.

A breach of the duty of loyalty exists when there is an illicit gain either for the director or damage to the corporation caused by unfair dealing of the director with the corporation (Urtiaga 2004). The existence of damage to the corporation is not necessary for a breach of the duty of loyalty to occur when the director has committed an illegal act. Cases of unfair dealing can be classified broadly into three categories: directors' remuneration, self-dealing transactions, and usurpation of corporate opportunity. The American Law Institute (ALI)'s Corporate Governance Project states that a deal is fair if the corporation gets at least as much as it could have obtained in an arm's length transaction (Urtiaga 2004).

In their book, *The Economic Structure of Corporate Law*, Easterbrook and Fischel make this quite plain.

The corporate contract locates the uncertainties in the holders of the residual claims – conventionally the equity investors. They receive few explicit promises. Instead, they get the right to vote and the protection of fiduciary principles: they duty of loyalty and the duty of care. .. [T]hese attach to the residual claim because the holders of these claims bear the marginal risks of the firm and so have the best incentives to make the optimal investment and management decisions – not perfect incentives, just best (Marcoux 2003).

[T]he only promise that makes sense in such an open-ended relation is to work hard and honestly. In other words, the corporate

contract makes managers the agents of the equity investors but does not specify the agents' duties. To make such an arrangement palatable to investors, managers must pledge their careful and honest services (Marcoux 2003).

A Matter of Trust

Management theory is prescriptive. Its purpose is to provide an account that will guide management decision making in ways designed to increase the chances for success (Cragg 2002). Management theories are prescriptive because they are built on assumptions about the nature and purpose of private sector investor-owned corporations. What virtually all management theories assume is that the purpose of a management theory is to provide the foundations for successful management. Successful managers are managers who do well what managers are supposed to do. Exactly what role managers should play in a given corporation should be defined by the nature and purpose of that corporation. The purpose of the corporation in conventional terms is to maximize profits for the benefit of the people who have invested in it and who are by virtue of their investment the corporation's owners. Managers, therefore, have an obligation to maximize share value for the benefit of investors (Cragg 2002).

Some scholars believe that stock analysts, for example, are actually an impediment to sound investing because they are more concerned about the next quarter's earnings instead of the long-term health of the corporation (Ingley 2004). Many institutional investors, also using a short-term gain mentality, propagate the problem because of their lack of investment in long-term gain (Ingley 2004). Unfortunately, individual shareholders typically do not have the infrastructure or funds to influence

corporate matters and are typically silent on areas of governance (Ingley 2004). The result is that shareholders “vote with their feet,” which has helped to generate management entrenchment (Ingley 2004). Presenting a political perspective of corporate governance as a democratic system, it is argued that corporate managers were powerful because they were relatively unchecked due to weak exit or non-existent exit voice (Ingley 2004). In both the United States and the United Kingdom, shareholders have little choice but to vote for the incumbent board members unless they take control of the entire nomination process themselves (Ingley 2004). Scholars contend that the Securities Exchange Commission mandate should force more activism by making it compulsory for institutional investors to vote their proxies and disclose how they voted (Ingley 2004). It would direct fund managers to set as their highest priority good long-term financial results for their beneficiaries, then call for more public assessment of their performance in that context (Ingley 2004). It should pressure top executives of institutional investors to involve their organizations more in monitoring governance (Ingley 2004).

The courts in the thirty Organisation for Economic Development and Cooperation member countries, such as the United States, the United Kingdom, Japan, Germany, and France have generally accepted the idea of managers’ duty of loyalty to shareholders, although the appropriateness of this duty is often challenged by those who believe that managers should also have a duty of loyalty to employees, communities, creditors, the state and other stakeholders, as set forth in the Organisation for Economic Development and Cooperation Principles (Ingley 2004). Also, a duty of boards is to protect the corporate capital structure from the capture of excessive profits by any single constituency (Ingley 2004). These are the points of contention between shareholder or

stakeholder priorities. A traditional criticism of viewing directors as owning a fiduciary duty to corporate stakeholders other than shareholders is that one cannot serve two masters (Ingleby 2004). Directors must learn what motivates and moves shareholders, the sleeping giant of corporate governance (Ingleby 2004).

Scholars have suggested that independent professionals should be utilized to vote as proxies (Ingleby 2004). Lawyers can also play an important role in increasing shareholder voice and loyalty (Ingleby 2004). The role of corporate counsel as co-agent with corporate management, having an independent fiduciary duty to the best interest of the entity and its management, is essential to assist the corporate board in meeting its obligations (Ingleby 2004).

Endemic problems associated with corporate governance failure capture the high ground in the governance debate (Ingleby 2004). The Board of Directors, the ultimate decision makers for the corporate entity, armed with more comprehensive information derived from constituents with greater voice and loyalty, could hold managers more accountable (Ingleby 2004). For example, The Responsible Corporate Officer (RCO) doctrine holds a corporate officer vicariously liable for the criminal violation of a subordinate (Kushner 2003). The RCO doctrine also imposes liability upon officers for the illegal acts of other corporate agents, without proof that the officers directly participated in or authorized the crime (Kushner 2003). However, in practice, an officer cannot be held liable for acts performed by other corporate agents unless it can be proved that they acted under the officer's direction or with his permission; this requirement is rooted in the agency principle that the officer as principal can only be liable for the crimes of a subordinate who was acting as his agent (Kushner 2003). Under the "superior

agent” rule, however, corporate liability may be restricted to acts authorized by the Board of Directors or senior managers (Kushner 2003).

Whereas a corporation is liable for crimes of its agents acting on its behalf in the scope of employment, a corporate officer is generally not liable unless he personally participates in or aids and abets a criminal act (Kushner 2003). Under the doctrine of *respondeat superior*, a corporation is vicariously liable for a criminal act of an agent where the act is within the scope of the agent’s employment and is done with intent to benefit the corporation (Kushner 2003). Furthermore, the RCO doctrine is best understood as an *imputation* of the acts constituting the violation to the officer. Imputation is a form of vicarious liability in which senior officers may be held criminally responsible for the acts of low-level employees (Kushner 2003). For example, an agent may bind a principal to an unwanted contract with another (Scordato 2004). The principal may be liable to third parties for torts inflicted upon them by the agent (Scordato 2004). A principal may be deemed to have legally received certain knowledge or notice that has in fact been received only by the agent (Scordato 2004). Generally known as the ‘imputed knowledge rule’ this aspect of agency law legally charges the principal with information obtained by the agent within the scope of the agent’s service for the principal (Scordato 2004).

Agency theorists saw the public corporations as “the nexus for a complex set of voluntary contracts among customers, workers, managers, and the suppliers of materials, capital, and risk bearing,” whose respective rights were determined by “law, the corporation’s charter, and the implicit and explicit contracts with each individual (Sharplin 2003).” However, “Shareholders are the only constituency of the corporation

with a long-term interest in its survival (Sharplin 2003).” The Working Group on Corporate Governance stated, “Shareholders should recognize and respect that the only goal common to all shareholders is the ongoing prosperity of the company (Sharplin 2003).”

When assigning moral responsibility, should a corporate organization be treated as one, or as a multitude? That is, can a corporate organization itself be morally responsible for its actions, much a like a large-scale human being, by taking a “collectivist” view? Or, is a corporation a multitude of inter-related people, each of whom is more or less morally responsible for what the organization does, which is taking an “individualist” view, and reject, therefore the idea that the corporate organization has some additional share of moral responsibility that is distinct from the responsibility that can accrue to each of its members (Velasquez 2003). The collectivist still holds that both individual human beings and corporate organizations can be morally responsible agents (Velasquez 2003). The individualists hold that human beings, but not corporate organizations, can be the only morally responsible agents (Velasquez 2003).

Stakeholder theory, however, holds that managers should make decisions to take account of the interests of *all* the stakeholders in a firm (Jensen 2002). For example, Jensen proposes a Value Maximization Proposition, which is that managers should make all decisions to increase the total long-run market value of the firm (Jensen 2002), which is derived simply from the long-term market value of social and supplier value’s stream of benefits (Jensen 2002). The problem with stakeholder theory is that it provides no criteria for what is better or what is worse, leaving Boards of Directors and executives with no principled criterion for problem solving (Jensen 2002).

Two hundred years of studies of work in economics and finance indicate that social welfare is maximized when all firms in an economy maximize total firm value (Jensen 2002). The intuition behind history's criterion is simply that social value is created when a firm produces an output or set of outputs that are valued by its customers at more than the value of the inputs it consumes, as valued by their suppliers, in such production (Jensen 2002). Firms trying to follow stakeholder theory will eventually fail if they are competing with firms that are behaving as so to maximize value. Stakeholder theory is embraced by directors and executives because stakeholder theory provides no definition of better, leaving managers and directors unaccountable for their stewardship of the firm's resources (Jensen 2002). Also, with no criteria for performance, managers cannot be evaluated in any principled way. Therefore, stakeholder theory plays into the hands of self-interested managers, allowing them to pursue their own interests at the expense of society and the firm's financial claimants. It allows managers and directors to invest in their favorite projects, even when they destroy firm value, without having to justify the value destruction (Jensen 2002).

Jensen further proposed *Enlightened Value Maximization* and *Enlightened Stakeholder Theory*. *Enlightened Stakeholder Theory* adds the simple specification that the objective function of the firm is to maximize total long-term firm market value (Jensen 2002). *Enlightened Value Maximization* recognizes that communication with, and motivation of, an organization's manager, employees, and partners are extremely difficult and works publicly to find the balance. Managers and directors become accountable for the assets under their control, because the value scorecard provides an objective yardstick against which their performance can be evaluated (Jensen 2002).

Economists identify two aspects of management's "principal's problem" as adverse selection, referring to the risk that agents may misrepresent their abilities and claim to provide outcomes they know they cannot, and the moral hazard, on which most applications focus, referring to the risk that agents will put in less effort than agreed toward achieving their principals' objectives (Hendry 2002). Furthermore, principals can address the problems of adverse selection and moral hazard in two ways: they can monitor agents' actions, or they can use outcome-based compensation (incentive pay) to align the agents' interests with their own (Hendry 2002).

The "Business Judgment Rule" gives management exclusive authority for the conduct of the affairs of a company, but requires that they exercise their responsibility with the exclusive financial interests of the company's shareholders in mind (Cragg 2002). Clarkson points out that those corporate decisions are usually made because of market forces, for example, employee productivity or customer satisfaction, but not necessarily because they are socially desirable. Managers are interested in results, first and foremost. Furthermore, performance is what counts. Performance can be measured and evaluated. Whether a corporation and its management are motivated by enlightened self-interest, common sense, or high standards of ethical behavior cannot be determined by the empirical methodologies available today. Finally, fairness and balance in the distribution to its primary stakeholder groups of the increased wealth and value created by the firm are necessary to preserve the continuing participation of each primary group in the firm's stakeholder system and to avoid favoring one group unduly and at the expense of other groups (Cragg 2002).

An ideal system would align the interests of shareholders and senior management so tightly that the need to appeal to the fiduciary obligations of managers would become without purpose. The effect is to turn managers into “purse” agents whose goals and objectives as managers are solely those of their principals; those goals and objectives are assumed in turn to be profit maximization. No publicly held corporations or management theorist would publicly adopt the view just described, of course. Stripping human beings of their character as moral agents is to strip them of their character as human beings. It is, as Kant put it, to see managers as a means only. This view of manager-agents constitutes, therefore, a fundamental challenge to the view that moral personality is inalienable. The view that moral personality or agency cannot be relinquished, sold, or otherwise alienated by individuals is a fundamental tenant of law. It follows on both legal and moral grounds that any theory of management must make a place for moral agency in its account of the role and responsibilities of managers (Cragg 2002).

In *Perira v. Cogan*, the courts found board members liable for breaching their fiduciary duties of loyalty and care through their inaction, and, by this inaction, failed to fulfill their roles as monitors of the company. Professor John Coffee of Columbia University Law School said that this case is important because it not only tells officers what their roles are, but it also tells director that they can be held liable even for decisions they did not make (Launcheimber 2003). The description of directors as trustees for the stockholders was also noted by the Delaware Supreme Court as early as 1922 in the case of *Lofland v. Cahall*, but the trust theory was best expressed in the seminal case of *Guth v. Loft, Inc*, a 1939 decision in which the court applied the trust analogy to the question of corporate opportunity. In condemning the actions of directors who sought to divert a

corporate opportunity to their personal benefit, the court expressed what has become, over time, a bedrock principle of corporate law (Walsh 2002). The decision stated corporate officers and directors are not permitted to use their position of trust and confidence to further their private interest. While technically not trustees, they stand in a fiduciary relation to the corporation and its stockholders. A public policy, existing through the years, and derived from a profound knowledge of human characteristics and motives, has established a rule that demands of a corporate officer or director, peremptorily and inexorably, the most scrupulous observance of this duty, not only affirmatively to protect the interests of the corporation committed to his charge, but also to refrain from doing anything that would work injury to the corporation, or to deprive it of profit or advantage which his skill and ability might properly bring to it, or to enable it to make in the reasonable and lawful exercise of its powers (Walsh 2002).

Equitable authority, whether exercised separately as in Delaware's Court of Chancery, or concurrently as in most jurisdictions, was historically invoked to hold trustees accountable for their actions with respect to the interests of the trust beneficiaries. Indeed, at common law the rights of beneficiaries could be recognized only in equity since beneficiaries lacked the legal title often essential to maintain an action at law (Walsh 2002). Although the fiduciary underpinnings of director responsibility have been clearly established, the decisional law has recognized a relaxation of the rigor of trust law, primarily with respect to tolerance of self-dealing transactions. The absolute prohibition at common law against self-dealing by a trustee has been modified in the

corporate setting to offer a safe harbor for directors of a corporation if the transaction is approved by a majority of disinterested directors or, in certain situations, by an approval of stated majorities of shareholders after full disclosure of the self-interest. This relaxation of the strict common law duty of loyalty is exemplified in statutory form under Section 144 of the Delaware General Corporation Law and represents a recognition that directors may, under certain safeguards, engage in self-interested transactions (Walsh 2002).

The classic articulation of the role of corporate directors as fiduciaries came in the early days of the Great Depression, in the form of a scholarly debate between Professor Adolf Berle of Columbia Law School and Professor Merrick Dodd of Harvard. Berle wrote that “managerial powers are held in trust for stockholders as sole beneficiaries of the corporate enterprise.” In reply, in language that still has currency today, Dodd stated that “public opinion, which ultimately makes law, has made and is today making substantial strides in the direction of a view of the business corporation as an economic institution which has a social service as well a profit-making function . . .” Incidentally, years later Berle conceded that events had proved Dodd correct (Walsh 2002).

The best interest of the corporation must be interpreted as the best interest of its shareholders. Very high transaction costs and asymmetric information make it impossible to write a contract that specifies completely the obligations of directors towards shareholders as the residual claimants of the profits of the corporation. Fiduciary duties complete these contracts because: “The only premise that makes sense in such an open-ended relation is to work hard and honestly (Urutiaga 2004).” Since fiduciary duties are meant to complete contracts the court should not try to impose any “desirable” standard

of care. It should rather try to enforce the standard agreed by the parties on the contract (Urtiaga 2004).

The premise of the contractual view of fiduciary duties is that the role of fiduciary duties is to fill gaps in contracts (Urtiaga 2004). The regulation of fiduciary duties is not faced with the need to accommodate the new view about corporate director's mission in governance. With regard to the duty of care, the new codes of conduct for corporate directors no longer regards directors as the managers of the business affairs of the corporation, but as monitors of the management team. As the management of the business is moved away from the board to the management team, the duty of care should also move away from the directors to the executives (Urtiaga 2004).

The term [fiduciary] is derived from the Roman law, and means (as a noun) a person holding the character or a trustee, in respect to the trust and confidence involved in it and the scrupulous good faith and candor which it requires. A person having duty, created by his undertaking, to act primarily for another's benefit in matters connected with such undertaking (Marcoux 2003).

To act as a fiduciary means to place the interests of the beneficiary ahead of one's own interests and, obviously, those of third parties, with respect to the administration of some asset or project (Marcoux 2003).

A director of a corporations, though not a trustee in the strict sense of reason that he has not title to the state, is a fiduciary because he and his fellow directors have control of the corporate property, and upon violating his fiduciary obligation, whether by sheer embezzlement, the director

comes under same obligation to his company that any agent is under who is faithless to his trust, and if corporation because insolvent its claims against director for an accounting, restitution, or equitable damages passes to its liquidator along with its other assets (Marcoux 2003).

According to Donald B. Trone, President, Foundation for Fiduciary Studies, Director of the Center for Fiduciary Studies, and CEO of Fiduciary Analytics, the first [fiduciary] case law was actually argued in 1830 in Harvard College v. Amory. [Trustees should] “observe how men of prudence, discretion and intelligence manage their own affairs, not in regard to speculation, but in regard to the permanent disposition of their funds, considering the probably income, as well as the probable safety of the capital to be invested (Journal of Financial Planning 2005).”

Existing regulations of the Securities and Exchange Commission and the National Association of Securities Dealers do not specifically address fiduciary standards of care (Journal of Financial Planning 2005). Black’s Law Dictionary, while defining a fiduciary as “one who owes to another the duties of good faith, trust, confidence, and candor the corporate officer is a fiduciary to the shareholder”, also cites in the definition from Waters, *The Constructive Trust* 4, that “Fiduciary is a vague term and has been pressed into service for a number of ends.” *Fiduciary responsibility*, as such, does not have its own definition in the law dictionary; however, there is a listing for fiduciary duty, which refers to Duty (2), which states, “any action, performance, task, or observance owed by a person in an official or fiduciary capacity.” Under the term “responsibility,” the primary definition is simply “liability.” Webster’s New World Diction has three parts to the definition, “a person who holds something in trust for another [a fiduciary guardian for a

minor child]; held in trust [fiduciary property]; and, valuable only because of public confidence and support; and in referring to “fiduciaries” it simply cites “trustee.” Webster used “being responsible” as a part of the definition of responsibility but also states that responsibility is, “a thing or person that one is responsible for (Payette 2001).”

In *Blatt v. Marshall and Lasser*, in finding an accounting firm to be a fiduciary because it controlled whether or not contributions were returned to plan participants, the court said, “Fiduciary status is determined by focusing on the function performed by the individual rather than on the individual’s title (Lohr 2004).” In *Perira v. Cogan*, a recent court decision based on Delaware corporate law, Judge Robert W. Sweet of the federal district court in Manhattan applied the same standard of fiduciary responsibility used for the directors and officers of public companies to the directors and officers of a closely held corporation (Taub 2003).

Although this duty of care is sometimes said to incorporate a “duty” to enrich shareholders, this “duty” is largely unenforceable. The duty of care is qualified by the so-called “business judgment rule”. Under this rule, courts do not evaluate directors’ business decisions under ordinary negligence principles but under a more deferential standard (Joo 2003). The business judgment rule is often interpreted to mean that shareholders may not attack the substance of directors’ business decisions, but may only question the board’s decision-making procedures. *Smith v. Van Gorkom*, one of the leading cases on the issue, requires directors to inform themselves before making business decisions. Leonard Baynes has advocated an aggressive approach to the duty of care in diversity issues based on this requirement. For example, Baynes argues that directors of broadcast corporations might be liable for breach of the duty of care for

failing to provide more programming that features and is aimed at minorities. According to Baynes, the boards' decisions not to create minority programming do not deserve the protection of the business judgment rule, because neither directors nor the offices and employees on whom they relied had fully informed themselves about the value of the minority broadcast audience (Joo 2003).

Delaware and many other states also require a shareholder filing a derivative lawsuit to show that there was a documented demand that the directors bring the cause of action on behalf of the corporation or that such a demand would have been a futile gesture (Joo 2003). Establishing futility requires pleading specific facts suggesting that the directors could not have impartially evaluated a demand or that the action complained of did not deserve the protections of the business judgment rule (Joo 2003). In the Van Gorkom case, for example, the court found a breach of due care, even though there was no clear finding of harm. The court found that the board had failed to disclose to shareholders its deficient procedure for reaching the recommendation (Joo 2003).

Current Practices

Federal Standard Accounting Board Statement 141 covers accounting for business combinations (Conigliaro 2002). Appendix A to SFAS 141 identifies five categories of intangible assets that must be identified and valued if held by the company being acquired: marketing related intangible assets, customer related intangible assets, artistic related intangible assets, contract based intangible assets, and, technology based intangible assets (Conigliaro 2002).

Federal Standard Accounting Board Statement 142 covers accounting for goodwill and intangible assets (Conigliaro 2002). Federal Standard Accounting Board

Statement 142 also requires goodwill of a reporting unit to be tested more frequently than annually if certain of the following indicate are present: loss of key customer, loss of key personnel, significant adverse changes in legal factors or business climate, unanticipated competition and, among other indicators (Conigliaro 2002). According to Young (2003), the classic definition of goodwill is

the advantage or benefit, which is acquired by an establishment, beyond the mere value of the capital, stock, funds, or property employed therein, in consequence of the general public patronage and encouragement, which it receives from constant or habitual customers, on account of its local posture, or common celebrity, or reputation for skill or affluence, or predictability, or from other accidental circumstances, or necessities, or even from ancient partialities, or prejudices.

Goodwill has also been redefined to include, “factors such as the prestige and renown of the business, the ownership of a trade name or brand, and a record of successful operations over a prolonged period in a particular locality (Young 2003).”

Conventional wisdom formerly held that responsibility for internal controls was delegated to an organization’s financial group (Farrell 2004). Internal controls are owned by those within the business who manage daily operations and who depend on the controls for achieving their goals (Farrell 2004). Those internal-control assessments may produce several improvements: one, greater use of automated, or system-based controls; two, better evaluation of process risks and mitigation of risk; three, more uniform controls throughout the organization, and four, greater responsibility for controls assessment for the process owners (Farrell 2004).

The compliance procedures can also be used to weed out nonessential tasks and determine good practices within each business process: comparing controls between different business units, or within a company's operations in different countries, cutting the risk of error by using a more technology-based method of control rather than manual processes, using key performance indicators to gauge the effectiveness of a process across a span of risks and time periods, and getting feedback from control procedures on a worldwide basis, which can lead to better reporting capabilities (Farrell 2004). The internal auditor can play a vital role in linking internal control reporting. An auditor can help control process owners gain a better understanding of internal control assessment and testing, becoming a purveyor of best practices within the organization, generally enhancing the organization's understanding of internal controls by imparting subject-matter knowledge in this area, and monitoring the organizations' internal controls through testing and feedback on its control status (Farrell 2004).

In response to the mandates and recommendation of Sarbanes-Oxley, senior management may consider several other measures to enhance corporate accountability: assessing self-knowledge and knowledge of others in the organization, ensuring that a uniform process exists and is followed by other members of the organization that provides internal certification, assessing the impact of changes in the business that may have an effect on internal controls, obtaining formal internal management representation letters on a quarterly basis from internal accounting personnel for all subsidiaries, holding regular conference calls with accounting staff to review new accounting pronouncements and other items that facilitate the closing process, initiating a formal regular meeting with

key process owners or segments leaders to discuss activities that may influence accounting and disclosure (Farrell 2004).

The New Era - Intelligence

One of the most popular models for classifying intellectual capital is the Hubert Saint-Onge model developed in the early 1990s. It divides intellectual capital into three parts: human capital, structural capital, and customer capital. The Brookings Institute (Shaihk 2004) suggests that intellectual capital is comprised of four types of assets:

- 1) market assets,
- 2) intellectual property assets,
- 3) human-centered assets, and
- 4) infrastructure assets

A defining characteristic of a more knowledge-driven economy is the enormous flow of investment in human capital information and communication technologies. The new knowledge economy potentially offers unlimited resources, simply because the human capacity to create knowledge is immeasurable. Important contributions to the theory of investment in intangibles have emerged from three main streams: human capital theory, innovation theory, and new growth theories (Shaihk 2004).

In a study by Treasury and Risk Management (2004), nearly half (49 percent) of the companies surveyed said that intangible assets are primary source of shareholder wealth creation, but only 41 percent actually apply some metrics. Table 1, *Getting the Measure of Intangibles - How Important are Intangible Assets To your company?* outlines other findings. Establishing some boundaries is essential. One of the most workable definitions is that offered by the Organization for Economic Co-operation and

Development, which describes intellectual capital as “the economic value of two categories of intangible assets of a company: organizational (“structural”) capital; and human capital (Shaihk 2004).” Knowledge, or knowledge assets, includes ideas expressed in technology, such as expertise and inventions; the power of brands including market leadership (consumer knowledge); and employee skills, such as business skills and institutional memory (Lebens 2002). A company practicing intellectual capital management will treat this knowledge like working capital: Knowledge will be kept fluid and not stored within the company.

Intellectual capital management is about connection of knowledge with the market, not about collection of knowledge within the company (Lebens 2002). It involves managing the knowledge a company develops, the knowledge a company protects, the process of protecting this knowledge, the development of the knowledge portfolio, retention, maintenance and continuation of intellectual property efforts, and monetization of knowledge assets. A truly intellectual capital management-driven company will make intellectual capital management a centerpiece of its business strategy (Lebens 2002). Such a company exercises astute management over its intellectual capital, which it has inventoried and codified, and which it has a plan to monetize. It has metrics to measure performance under this plan. Moreover, it has committed resources to intellectual capital management (Lebens 2002).

Organizational capabilities are key intangible assets. These capabilities – the collective skills, abilities, and expertise of an organization – are the outcome of investments in staffing, training, compensation, communication, and other human

resources areas. Organizational capabilities emerge when a company delivers on the combined competencies and abilities of its individuals (Ulrich 2004).

One of the first information streams developed focuses solely on identifying the return on a company's investment in intangibles. Calculating the return on investment (ROI) is trickier in other areas, where the relationship between intangibles investments and their outcomes is more complex. For example, while there are a number of increasingly accepted methodologies for computing the returns on brand building investments, there is less consensus about how to determine returns on investment in human capital. Even where there is an apparent link between, say, employee training and productivity, it is not always possible to confirm a causal relationship between the investment and the positive result, given the variety of factors that affect employee productivity (Lev 2004). Breaking out a company's expenditures in training, brand enhancement, information technology, etc., from general cost figures would let managers and investors see how those investments change over time and how they compare with those made at related companies (Lev 2004).

The second dimension of information that companies can quantify and disclose involves their "intangible capital." Intangibles are rarely considered assets whose performance must be continually monitored. The expense mentality towards intangibles should be replaced by an asset mentality (Lev 2004). The primary benefit of having an asset mentality is that it drives management to structure the intangibles-related investments for maximum productivity and longevity. Viewing intangibles as assets also helps ensure that adequate property rights have been secured for them (Lev 2004).

A Misunderstanding of Purpose

Wayne Cascio, Professor of Management in the Business School, University of Colorado at Denver, found 6,418 occurrences of changes in employment for Standard and Poors 500 companies during the 18-year period from 1982 through 2000. As in an earlier study, he found no significant consistent evidence that employment downsizing led to improved financial performance, as measured by return on assets or industry-adjusted return on assets. Downsizing strategies, either employment downsizing or asset downsizing, did not yield long-term payoffs that were significantly larger than those generated by stable employers, that is, those companies in which the complement of employees did not fluctuate by more than +/- 5 percent (Cascio 2003).

It was just not possible for firms to “save” or “shrink” their way to prosperity. Rather, it was only by growing their business through “asset upsizing” that companies outperformed stable employers as well as their own industries in terms of profitability and total returns on common stock (Cascio 2003). Employment downsizing may not generate the benefits sought by management. Managers must be very cautious in implementing a strategy that can impose traumatic costs on employees, both on those who leave as well as on those who stay. Management needs to be sure about the sources of future savings, and carefully weigh those against all the costs, including the increased costs associated with subsequent employment expansions when economic conditions improve (Cascio 2003). According to Cascio (2003), there are nine things to consider before restructuring: the rationale behind restructuring; the virtues of stability; the concerns of employees about restructuring; the opportunity to address long-term problems; the perception among employees that the process of selecting excess positions

was fair and consistent in the event of layoffs; the regularity and variety of communications about new developments; the reasons why remaining employees should stay, or why prospective new hires should join; training of employees and their managers in the new ways of operating; careful examination of all management systems in light of the change of strategy or environment facing the firm.

To gain credibility, Human Resources professionals, too, must broaden their general business knowledge and, equally importantly, learn to align their activities with their organizations' strategic needs and priorities. They must be willing to take risks, to challenge leadership and exert influence at the "C-suite" level (Meisinger 2004). They must also have management on their side in order to improve performance; for example, beyond cutting costs, companies, in 73 percent of cases, want to use human capital for such a purpose (Human Resources Department Management 2005b). Refer to Table 2 for a breakdown of *How Will Companies Improve Performance Beyond Cutting Costs*.

The difficulty that many companies have in creating superior workforces and organizational capabilities can be traced in most cases to underperforming Human Resources and training organizations. A Human Resources operation is based on the following principles: that it exists in an organization because it adds tangible value by providing necessary services at a competitive cost.; that it's charter is to enhance the productivity and effectiveness of the organization from the people side: the talent, the human capital; that it should drive the organization's management in regards to people issues; that it is a professional function staffed by professionals dedicated to the development of people in ways that are satisfying to the individual and beneficial to the organization (Davison 2002, page 15-16). In response, based on a survey, the five most

important initiatives are improving worker productivity, improving the delivery of Human Resources services, improving the adaptability of the business to new opportunities, facilitating organizational change, and improving employee engagement with/advocacy for the company (Accenture 2004).

However, Human Resources takes a dim view of management communications, says a Novations Group study. Only one-quarter of nearly 3,000 senior Human Resources professionals believe management does a very satisfactory job (Human Resource Department Management Report 2004). Seventy four percent (74 percent) of Human Resource professionals are only “somewhat satisfied” to “not at all satisfied” with managerial communication (Human Resource Department Management Report 2004). Refer to Table 3 for a breakdown of *How HR Rates management communication*. This could be because one out of every two managers believes intangibles refers to solely Research and Development, intellectual property and goodwill, only as defined by traditional accounting standards (Accenture 2004). Refer to Table 4 for a summary of *What do you understand by the term “intangibles,” when used in a business context*. At a higher level, executives must move past the recognition that “people are key to our success” and embrace the fact that improving employee engagement, understanding where and how to develop critical capabilities and key talent that are aligned to business need, and enabling a culture of innovation and change are the key drivers of improving and sustaining high performance in the workforce and in the business overall (Accenture 2004).

The New Commodity

Intellectual capacity is the ability of a company to extract value from the organization's intellectual capital. Intellectual capital is composed of two types of organizational capital: intellectual property and a complex intertwining of processes and culture, plus relational capital and human capital. (Fitz-enz 2000, page 10). The second component is process management. One process capital issue that has been largely overlooked has to do with an organization's culture. Culture is the defining aspect of every organization. It is its "signature." This has caught on to such a degree that a currently popular cultural goal is to become an "employer of choice." *Fortune* magazine has jumped on this bandwagon with an annual issue devoted to "The 100 Best Companies to Work For." Relational information is those relations not only with customers but also with suppliers, partners, competitors, media, community government, stakeholders, etc. McKenna introduced the idea of relational information idea in 1986 when he argued that traditional product-focused marketing was an outdated relic. He claimed that building relationships was one of the three underpinnings of marketing: understand the market, move with it, and form relationships (Fitz-enz 2000, page 12).

The final element of this intellectual capital is dedicated to expanding the skills and knowledge of employees for the sake of the person as well as the company. There are two concerns here. The first is with trying to build "learning organizations" In short, according to Senge, who popularized the term, a learning organization is "a place where people are continually discovering how they create their reality." The second and related human concern is the right of the individual to trade on the knowledge that he or she

possesses. Eventually, one or more will work itself all the way through the legal system, and a body of human capital law will begin to emerge (Fitz-enz 2000, page 13).

As outlined herein, numerous factors have contributed to the theft of shareholder wealth. This was merely a summary of the key factors. Corporations must respond accordingly to these issues and problems before it is too late.

CHAPTER 3 – The Existence Of The Theft Of Shareholder Wealth

The existence of the theft of shareholder wealth can be attributed to numerous elements, all of which reveal that the inattention to the pursuit of maximal shareholder wealth is widespread, a public issue, and that corporations are already acknowledging the issues and wish to remedy them. This chapter will outline the following elements in detail:

- an increase in the development of laws and regulations, increased legal scrutiny, and an emphasis on corporate governance and transparency;
- an acknowledgement that a corporation's intangible assets are increasing in value, and as part of this increase an acknowledgement that human capital has never been more important to a corporation;
- as a result of the emphasis on intangibles, scholars and researchers have developed more intangible and human capital metrics to address these issues to add to the battery of industry ratios already in existence;
- as a result of the new intangible and human capital metrics developed there is proof shareholder wealth is effected by the amount invested in human capital and there is a significant difference between high performance and low performance corporations directly correlated with the level of human capital investment; and,
- because of the change in the workforce composition, corporations need to put much more emphasis on their human capital in order to recruit, retain, and maximize productivity of their workforce in order to grow, or simply stay in business.

External Intervention

There is an increase in the development of laws and regulations, increased legal scrutiny, and an emphasis on corporate governance and transparency. The Securities Exchange Commission (SEC), United States Congress, New York Stock Exchange (NYSE), the Organisation for Economic Co-operation and Development (OECD), the insurance industry, and institutional investors and fund managers have all implemented measures or guidelines to remedy issues within corporations to better regulate, or understand, the corporate strategic process.

The Securities Exchange Commission has now begun a process to identify and define the measures and metrics of enterprises in the knowledge economy, and demonstrate the ability of these measures and metrics to explain future earnings and market capitalization so that executives, analysts, and investors can make better, more reliable and rational decisions for their clients, constituencies, and shareholders (Lebens 2002).

The Sarbanes-Oxley Act of 2002 requires the Securities Exchange Commission to issue rules requiring a company to disclose whether it has adopted a code of ethics for its senior financial officers. In addition, the Securities Exchange Commission needed to issue

new rules that establish minimum standards of professional conduct for attorneys who practice before the SEC. These rules will require that an attorney report evidence of a material violation of securities laws or a breach of fiduciary duty or similar violation by the company or its agent(s)

to the company's chief legal counsel or its CEO (Investor Responsibility Research Center 2003).

The Sarbanes-Oxley Act of 2002 further requires additional Human Resources documentation. The provisions expand documentation requirements about executive compensation, payroll, pension plan costs and liabilities, health-care costs and liabilities, and employee benefits plans. Human Resources managers may need to demonstrate how they keep records, the source of their information, and how they verify its accuracy. Furthermore, Human Resources managers need to train employees on the new regulations and adjust reporting relationships to avoid conflicts of interest. Finally, among other items, Human Resources managers need to establish and conduct ethics training programs (Human Resources Department Management Report 2004a).

The New York Stock Exchange is implementing new guidelines for listed companies in the areas of compliance and accountability.

First, companies must adopt and disclose corporate governance guidelines addressing director qualifications and responsibilities, responsibilities of key board committees, and director compensation. The company website must include its corporate governance guidelines and the charters of its most important committees. Further, each company's annual report must state: 1) that the information is available on the website, and 2) that the information is additionally available in print for any shareholder who request it. Second, companies must adopt and disclose a code of business

conduct and ethics for directors, officers and employees, which addresses conflicts of interest, corporate opportunities, confidentiality, fair dealings, protection and use of company assets, compliance with laws and regulations, and encourages the reporting of any illegal behavior. The code of business conduct and ethics must 1) require that any waiver of the code for officers or directors may be made only by the board or board committee; and, 2) contain compliance standards and procedures that will facilitate the effective operation of the code. The code also must be included on the company website, available in print form to shareholders, and its availability disclosed in the company's Form 10-K.

The New York Stock Exchange revised guidelines do not address any insider trading or conflicts of interest and the New York Stock Exchange has developed a Directors' Institute expanding continuing education programs for corporate directors and officers through the New York Stock Exchange Foundation, and urges companies to establish orientation programs of their own (Investor Responsibility Research Center 2003).

Furthermore, as part of the New York Stock Exchange guideline reform, guidelines were established to

empower non-management directors to serve as a more effective check on management, the non-management directors of each listed company must meet at regularly scheduled executive sessions without management. In other words, to promote open discussion among the non-management

directors, companies must schedule regular executive sessions in which those directors meet without management participation. 'Non-management' directors are all those who are not executive officers, and includes such directors who are not independent by virtue of a material relationship, former status or family members, or for any other reason. In order that interested parties may be able to make their concerns known to the non-management directors, a listed company must disclose a method for such parties to communicate directly with the presiding director or with the non-management directors as a group (New York Stock Exchange 2004).

Finally, to further outline how the New York Stock Exchange desires its listed companies to operate, the listed companies must adopt and disclose a code of ethics and business conduct for its legal agents, i.e., board of directors, officers, and employees, and promptly disclose any waivers of the code for directors or executive officers. Conflicts of interest occurs when an individual's private interest interferes in any way – or even appears to interfere – with the interest of the corporation as a whole. A conflict situation can arise when an employee, officer, or director takes actions or has interests that may make it difficult to perform his or her company work objectively and effectively. The listed company should have a policy prohibiting such conflicts of interest, and providing a means for employees, officers and directors to communicate potential conflicts to the listed company. Corporate opportunities addresses when employees, officers and directors and their

prohibition from a) taking for themselves personal opportunities that are discovered through the use of corporate property, information or position, b) using corporate property, information, or position for personal gain, and c) competing with the company. Employees, officers and directors owe a duty to the company to advance its legitimate interests when the opportunity to do so arises. Fair dealing is when each employee, officer, and director should endeavor to deal fairly with the company's customers, suppliers, competition, and employees. None should take unfair advantage of anyone through manipulation, concealment, abuse, of privileged information, misrepresentation of material facts, or any other unfair-dealing practice. Protection of and proper use of company assets is where all employees, officers and directors should protect the company's assets and ensure their efficient use. All company assets should be used for legitimate business purposes. Finally, the encouraging the reporting of any illegal or unethical behavior. This listed company should proactively promote ethical behavior. The company should encourage employees to talk to supervisors, managers or other appropriate personnel when in doubt about the best course of action in a particular situation (New York Stock Exchange 2004).

On the global front, the Organisation for Economic Cooperation and Development, founded in 1961, and of which the United States was a charter member, drafted guidelines for disclosure and transparency, providing guidelines for the disclosure of issues regarding employees and other stakeholders. It outlines the role of stakeholders

in corporate governance, including provisions to create performance-enhancing mechanisms for employee participation. Stakeholders, including individual employees and their respective bodies, should be able to communicate their concerns about illegal or unethical practices to the board and their rights should not be compromised for doing such (Organisation for Economic Cooperation and Development 2004).

Secondary to shareholders, the insurance industry has a significant interest in poor human capital management. The Chubb 2004 Private Company Risk Survey of 300 executives of privately held companies states that

Fifty-six percent of the responding organizations have no plan to seek the opinion of HR in workplace decisions, although many acknowledge this is a perilous practice. Nearly a quarter of employers say they expect to be hit with a fiduciary liability lawsuit in 2004 and half say it is likely an employee will file a discrimination complaint. Of the companies surveyed, 26% said an employee or former employee has sued the company or its directors or officers in the past few years, and 22% said an employee has filed a discrimination complaint with a state or federal agency. During the five-year period from 1997 to 2001, the EEOC obtained \$409.7 million in monetary relief for private plaintiffs in employment discrimination actions (Human Resource Department Management Report 2004).

Based on an American survey of 240 institutional investors and fund managers it was concluded that institutional investors and fund managers see corporate governance and transparency, such as that outlined, primarily as a means to an end in protecting or improving financial performance (Ingley 2004). As a result, they have begun to exercise

their abilities as shareholders and in many cases vote through independent proxy for the betterment of the corporation's long-term health instead of a short-term gain.

Finally, though not through legal means, corporations are finding it beneficial to be known as a company "good to work for." Indeed, 80 percent of corporations that were on Fortune's 2002 and 2003 lists of "The 100 Best Companies to Work For" avoided layoffs in the prior year, and nearly half of them even have official policies prohibiting layoffs (Cascio 2003). In examining Fortune's "The 100 Best Companies to Work For" from 1998-2001, a period of both economic growth and recession, Cascio (2003) examined the performance of these companies relative to the Standard and Poor's 500 and the Russell 3000, in several ways: "portfolios of their stock that were equally weighted and capitalization-weighted, and portfolios based on buying and holding the 100 companies in the 1998 list, versus rebalancing each year as a new list of the 100 Best came out. Without exception, the portfolios comprising stocks from firms on the 'Best 100' list outperformed the market benchmarks by factors that varied from 1.185 to 3.43 over the three-year period (Cascio 2003)." The public proof that an investment in human capital is profitable bodes well for shareholder wealth.

Valuation Of The Intangibles

The intangible assets of corporations are increasing in value and, as part of this, human capital has never been more important to a corporation. According to the Brookings Institute, as recently as 1978 companies were "typically valued at 80 percent tangible assets and 20 percent intangible assets. By 1997, this ratio had practically reversed, with roughly 30 percent of assets being attributable to tangibles and the remainder being attributable to intangibles (Lebens 2002)." Comparing the market-to-

book value of the Standard and Poor's 500 from 1977 to 2001, the value ratio has risen from 1 to over 6 during the past 25 years suggesting that for every \$6 of market value, only \$1 actually appears on the balance sheet (Smallwood 2003, page 6-7). In another study, "for 8 out of 9 cases, the value of intellectual property and intellectual assets makes up more than 80 percent of the corporation's market value (Kurz 2000)."

"Intangible assets – a skilled workforce, patents and know-how, software, strong customer relationships, brands, unique organizational designs and processes, and the like – generate most of corporate growth and shareholder value. They account for well over half the market capitalization of public companies," according to Lev (2004).

Comprehensive data on a corporation's intangible assets give shareholders a better understanding of the corporation's capital. These data,

reflecting both tangible and intangible assets, will yield better metrics than such widely used measures of investment value as the market-to-book ratio. The Generally Accepted Accounting Principles already requires that certain identifiable intangibles acquired from other entities be reported as assets, but not those developed in-house (Lev 2004).

With regard to currently measured intangible business units,

annual rates of return on Research and Development have in recent decades hovered in the range of 25% - 30%. This is substantially above the returns on physical assets and above firms' cost of capital, even after accounting for the relatively high risk of Research and Development (Lev 2004).

The value of intangibles does not go unnoticed; the Cap Gemini Ernst and Young's (CGEY) "Decisions That Matter" research showed that at least 35 percent of portfolio managers' decisions about where to allocate investment dollars are based on intangibles (Kalafut 2003). Table 5 outlines the *Top Ten Non-financial Variables Considered by Financial Analysts*. In addition, Watson Wyatt's Strategic Rewards survey shows that

organizations that view their people strategy as a source of competitive advantage are outperforming those that do not by a margin of more than two to one. These companies delivered a median TRS [Total Return to Shareholders] of 109 percent between 1996 and 1998, versus 52 percent for other employers. The Strategic Rewards research provides key insights for organizations aiming to recruit and hold on to top-performing employees (Kay 2002, page xxi-xxiii).

To further the importance of intangibles, "the top 100 U.S. companies in 1999 employed 3 percent fewer workers than did the top 100 companies a decade earlier. But the collective market capitalization of these companies in 1999 was a full 500 percent higher than the top 100 the decade earlier (Kay 2002, page xxxi)."

However, even with the proof that there is value in the intangibles, including human capital, not all business leaders see the benefit and actually work towards human capital investment. In a study conducted by the Society of Human Resources Management (Meisinger 2004), the trade association received numerous responses to its question of "Can HR help improve bottom-line performance?"; the key highlights are:

- “Management of human capital is very much a critical component of our bottom-line success”
- “I don’t think . . . they can help the bottom line. The important thing is for them not to hurt the bottom line.”
- “HR’s leadership in retention and training of employees, as well as overall employee’s satisfaction, drops right to the bottom line for us.”
- “They should be able to, but most can’t contribute much. It is an area that the profession has to continue to work on.”

Only eighteen percent of all executives said they are very satisfied with the overall performance of their human resources function, while 16 percent said they are satisfied with the training function (Accenture 2004). Only twelve percent of executives reported being very satisfied with their performance in ensuring that they are pursuing learning strategies that explicitly support the mission of the business (Accenture 2004). When executives were asked to describe the overall skill level of their workforce, only 17 percent said it was industry leading, while just under 40 percent said it was either equal to or worse than their competitors (Accenture 2004). Meanwhile, “The average organization has a Staff Efficiency Ratio of 14.15 percent, i.e., for every \$10,000 of new hire compensation, organizations are spending \$1,415 to recruit,” leaving a substantial amount of room for improvement (Human Resource Department Management Report 2004).

Accenture (2004) outlined that five training initiatives that respondents identified as their most important are:

- Aligning learning strategy with business goals

- Ensuring learning content meets workforce requirements
- Boosting workforce productivity and agility
- Measuring the learning function against business objectives
- Improving the efficiency of training operations

However, only six percent of participants said they were satisfied with their progress on the top-rated initiative, improving worker productivity. (Accenture 2004).

Twenty percent of executives – up from 12 percent in a 2003 study – said that three-quarters or more of their employees understand the company’s strategic goals, while 41 percent said fewer than that have such an understanding. Furthermore, only 22 percent of executives – a jump from 17 percent in a 2003 study – said that at least three-quarters of their employees understand how their job contributes to the company’s ability to achieve its strategic goals, while 40 percent said fewer than half have such an understanding (Accenture 2004).

Development Of New Metrics

Because of the emphasis on intangibles, scholars and researchers have developed more intangible and human capital metrics to address these issues to add to the battery of industry ratios already in existence. A measurement system provides a frame of reference that helps management carry out several important responsibilities, including the following: communicate performance expectations, see, feel and understand outcomes, compare to standards and/or benchmarks, identify performance gaps, support resource allocation decisions, and recognize and reward performance (Davison 2002, page 17-18). Since human capital costs today can exceed 40 percent of total corporate expense, measuring the return on investment in human capital is essential (Fitz-enz 2000, page 3).

In July 1980, the Saratoga Institute, with what is now known as Society for Human Resources Management, assembled 15 Human Resources professionals to develop the first set of formulas for measuring the work of Human Resources functions. Virtually all major consultancies use and refer to the Saratoga Institute measures. More than 15 years after its inception, it is clearly the worldwide standard for measuring and evaluating human capital performance. Table 6 outlines the *Saratoga Institute Human Capital Benchmarks*. It is important to note that the focus is not on the Human Resources function but on total human capital investment (Davison 2002, page 22-23).

Conceptual support for Market Value Added (MVA) is based partly on its association with Economic Value Added (EVA). A fundamental flaw with MVA is that it does not distinguish between wealth created recently and wealth created in the distant past (Keef 2002). There are three levels at which the leverage of human capital investments can be measured: the enterprise level, business unit, and human capital management (Fitz-enz 2002, page 20). For purposes of this topic, the primary focus will be on human capital management.

In applying value to human resources capital, Watson Wyatt found that recruiting and retention excellence had a 7.9 percent impact on market value, total rewards and accountability had a 16.5 percent impact, collegial, flexible workspace had a 9 percent impact, communications integrity had a 7.1 percent impact, and focused human resources service technologies had a 6.5 percent. Table 7 outlines, in detail, the *Watson Wyatt's Human Capital Index – Links Between Human Capital Practices and Value Creation*. Furthermore, in another study conducted by Watson Wyatt regarding the key links between capital and global shareholder value creation, 10.1 percent was contributed to

recruiting excellence. Table 8 outlines the *Key Links Between Human Capital and Global Shareholder Value Creation*.

Companies that have a deep understanding of the role of knowledge in their business treat it as an asset. Measuring and reporting information on their intangibles has the potential to improve their management and decision-making and creates significant business opportunities. The most common internal measures of intellectual capital focus on budgeting, training, and human capital. According to Shaikh (2004), the four most popular internal measures of intellectual capital are Human Resource Accounting, The Intangible Asset Monitor, The Skandia Navigator, and The Balance Scorecard.

Human Resource Accounting (HRA)'s objective is to improve the management of human resources from an organizational perspective – by increasing the transparency of human capital costs, investment, and outcomes in traditional financial statements, and to attempt to improve the basis for investors' company valuation (Shaikh 2004).

The *Intangible Assets Monitor* (IAM) was developed as a management tool for corporations wanting to measure and value their intangible assets, specifically for the difference between market and book value. The Intangible Assets Monitor is founded on the assumption that people are a corporation's only profit generators and, in turn, human actions are converted into both tangible and intangible knowledge structures (Shaikh 2004).

The *Skandia Navigator* is founded upon the same broad conceptual framework as the Intangible Assets Monitor, but measures both the financial focus and intellectual capital (Shaikh 2004).

The *Balanced Scorecard* is an organizational framework for implementing and managing a strategy at all levels of a corporation by connecting objectives, efforts, and measures to a corporation's vision and strategy (Shaihk 2004).

There are also numerous other external measures by which intangibles can be measured, such as the market-to-book values, Tobin's Q, Calculated Intangible Value, and Real Options-Based Approach (Shaihk 2004). Market-to-book value is the difference between the market value of the company and its book value. Tobin's Q compares a company's market value with the replacement cost of its assets. Calculated Intangible Value uses averages to determine value. Real Options-Based Approach uses methodology and theory of financial options to value intangible assets (Shaihk 2004).

How well accounting has ignored human capital can be seen in practically any book on business ratios. A typical example is *The Vest-Pocket Guide to Business Ratios*. In over 300 pages, the only time that employee-related metrics show up is as costs, never as leverage. The guide closes with a list of thirteen ratios that are published by the likes of Dun and Bradstreet, Standard and Poors, Moody's Value Line, and Robert Morris Associates. Not a single one involves human capital, even as a cost element. Standard accounting fails to solve today's mandate at two levels. First, accounting looks inside the organization. Its primary role is to conserve the assets of the enterprise. Second, it is focused on the past. If we want an internal, backward look, accounting does the job. Conversely, today we need to focus on the issues that will create wealth, the actions that will extract value from the marketplace. Moreover, we need to focus on the future. We

cannot be successful by backing into the future with our eyes locked on the past. The advent of new forms of accounting – namely, economic value added and the balance scorecard approach – is a promising step in the right direction (Fitz-enz 2002, page 5).

Finally, it has been advocated that a value-chain scorecard be created to track intangibles and forming an accounting policy-making body with input from the Securities Exchange Commission to standardize and track intangible information. Harvard professor Robert Eccles and his colleagues at PricewaterhouseCoopers (PwC) call for a “value reporting revolution” by changing financial reports to include more intangible information. They found that only 19 percent of investors and 27 of analysts “found financial reports very useful in communicating the true value of companies.” Studies, one of which (by PwC) asked CFOs, heads of investor relations, and other executives to evaluate 37 performance indicators. They found three clusters of performance indicators that mattered most: customers, employees, and innovation (Smallwood 2003, page 8).

Another more recent metric is from The Accenture Institute for Strategic Change, where it was developed and field-tested in what Accenture calls the Human Capital Development Framework (HCDF). The Human Capital Development Framework combines best practices in the fields of human resource development, learning and knowledge management with state-of-the-art measurement techniques to identify specific company needs and target interventions. Though the results are preliminary, they are

nonetheless encouraging the validity of the Accenture Human Capital Development Framework as both a diagnostic tool and a predictive model. This simple framework provides a foundation for assessing an organization's current capabilities with regard to human capital development. The result is a human capital development scorecard that presents an organization's ability to use human capital to generate business results (Cheese 2003).

Human Capital

As a result of the new intangible and human capital metrics that have been developed, there is proof shareholder value is affected by the amount invested in human capital.

If diversity contributes to a more productive workforce, as corporations seem to acknowledge, it seems to follow that it should also make for good leadership. Once recent empirical study found that increased firm value correlates with board diversity (Joo 2003). "Shareholders in public corporations do not in any realistic sense elect boards. Rather boards elect themselves (Joo 2003)." Starting at the top, in a study, they found statistically significant positive relationships between the presence of women or minorities on the board and firm value, as measured by Tobin's Q. In addition, the study provided important evidence of a positive relationship between firm value and diversity on the board of directors (Carter 2003). Meanwhile,

Thirty five percent of workers are actively seeking new jobs and 40 percent more are passively looking for new job opportunities, according to a 2004 survey conducted by the Society for Human Resources Management (SHRM) and CareerJournal.com. The SHRM/CareerJournal

survey found that receiving higher compensation was a motivating factor for 43 percent of job seekers, while 32 percent wanted better career opportunities, and 22 percent are dissatisfied with opportunities in their current jobs (Kinsman 2004).

Walker Information's own survey of workers in 2003 found "31 percent felt trapped in their jobs and an additional 34 percent were unhappy in their work. 'It's clear to us there is a lot of discontent,' Woolard says. He believes workers feel alienated by companies' aggressive layoffs and cost cutting of recent years (Kinsman 2004)."

Watson Wyatt's WorkUSA 2000 research responds with the employee perspective.

WorkUSA 200 surveyed 7,500 U.S. workers at all job levels and in all major industry sectors. This survey, the sixth conducted since 1987, shows a clear linkage between employee satisfaction and shareholder returns. Companies with high employee commitment have dramatically higher three-year total return to shareholders – 112 percent versus 76 percent.

The average was 90% (Kay 2002, page xxi).

A Watson Wyatt study computing the Human Capital Index (HCI) shows a clear relationship between the effectiveness of a company's human capital management and shareholder value creation. They surveyed more than 750 publicly traded companies in North American and Europe (Kay 2002, page xvi-xvii). During the 5-years studied, low Human Capital Index companies had a 5-year total return to shareholders of 21 percent, while high Human Capital Index companies showed 64 percent. Medium Human Capital Index companies had 39 percent (Kay 2002, page xvi-xvii). With the Human Capital

Index, the relationship was so clear that a significant improvement in 30 key Human Resources practices was associated with a 30 percent increase in market value (Kay 2002, page 302). Table 7, again, outlines the *Watson Wyatt's Human Capital Index- Links Between Human Capital Practices and Value Creations*. Watson Wyatt's study demonstrated that Human Resources practices are

not only associated with business outcomes, but also created them.

Moreover, a careful inspection of all the data shows that for every available correlation calculated over time, the relationship between past Human Resources practices and future financial performance is stronger than the relationship between past financial outcomes and future Human Resources practices (Watson Wyatt n.a.2).

In an example, economist Kathryn Shaw studied 36 integrated steel finishing companies. Shaw and her team found

that the higher an organization operates on the Human Resources innovation scale, the higher the productivity gain compared to traditional Human Resources and training practices. Gains translated into as much as 6.7% more "uptime" – the percentage of time the plant is running vs. being down due to problems. Average plant uptime is about 88%. If innovative Human Resources and training practices add 6.7% to that, uptime rises to 94.7%, a substantial gain (Human Resources Department Management 2005a).

In a 1995 award-winning study by Mark Huselid, Huselid surveyed 968 senior human resources professional out of a sample of 3,452 firms

representing all major industries. “The magnitude of the returns for investment in High Performance Work Practices is substantial. A one standard deviation increase in such practices is associated with a . . . 7.05 percent decrease in turnover and, on a per employee basis, \$27,044 more in sales and \$1,841 and \$3,814 more in market value and profits, respectively.” One standard deviation above the mean puts the company in the upper 6 percent of all those in the study in terms of its use of high commitment work practices. But the economic returns for those implementing these policies have been enormous – more than an \$18,000 increase in stock market value per employee. A subsequent study conducted in 1996 of 702 firms, using a somewhat more comprehensive conception of the human resource management system, found even larger economic benefits: “A one standard deviation improvement in the Human Resources system index was associated with an increased in shareholder wealth of \$41,000 per employee.” Since the average stock market value per worker for all of the firms in the sample was about \$300,000, firms in the upper 16 percent of the distribution in terms of their use of high performance management practices experienced about a 14 percent market value premium. Similar results were obtained in a study of more than one hundred German companies operating in ten industrial sectors. The study found “a strong link between investing in employees and stock market performance.” Companies which place workers at the core of their

strategies produce higher long-term returns to shareholders than their industry peers (Pfeffer 1998, page 35).

Most importantly, 79% of initial public offerings with one standard deviation above the mean survived for at least five years whereas with one standard deviation below resulted in only 45% survival rate. Table 9 outlines the *Probability of an initial public offering firm surviving five years*. Furthermore, Table 10 outlines in detail the *Comparison of High and Low HR Management Quality* metrics between the bottom 10% performers and the top 10%.

Twenty-seven percent of companies surveyed will be “undertaking company-wide performance improvement initiatives to refine current processes,” according to the latest results from the Leadership Pulse Study conducted by Dr. Theresa Welbourne of the Ross School of Business, University of Michigan, and eePulse, Inc. “These results indicate that leaders are seeking help from within; reading through the detailed comments you realize how much senior executives are looking to their workforce for ideas and help in improving firm performance,” states Welbourne (Human Resources Department Management 2005b).

Accenture’s recent *The High Performance Workforce Study 2004* found that “the link between human capital investments and business performance is one of the most compelling findings of this year’s study,” says Peter Cheese, Accenture managing partner, human performance. He also noted, “companies that master the human capital capabilities they believe are absolutely critical to their success” show “a significantly higher return to shareholders over time (Human Resources Department Management 2005a).”

In a study conducted by Johnson and Richard (2004), they found support for the argument that

High Performance Work Practices (HPWP) are associated with increased innovation, Human Resources Management effectiveness is associated with increased performance, and together both High Performance Work Practices' and Human Resources Management effectiveness is associated with both goals. Firms that have both High Performance Work Practices' and Human Resources Management effectiveness are the most successful on both innovation and market performance measures (Johnson 2004).

Future Of The American Workforce

As a result of the changes in the workforce, corporations need to emphasize their human capital in order to recruit, retain, and maximize productivity of their workforce if they are going to grow or simply stay in business. "The United States workforce will continue to increase in size, but at a considerably slower rate. Slower workforce growth may make it more difficult for firms to recruit workers during periods of strong economic growth (Karoly 2004)." During the 1990s, the workforce grew at an annual rate of just 1.1 percent, in contrast to the 1970s when it grew at an annual rate of 2.6 percent (Karoly 2004). According to a study by the RAND Corporation,

between 2000 and 2010, the annual growth rate is projected to equal the rate in the 1990s of 1.1 percent. In the decade that follows, the rate of growth is projected to slow to just 0.4 percent, followed by an even lower 0.3 percent annual growth rate between 2020 and 2030. The slowdown of the workforce growth rate may make it more difficult for firms to recruit

workers in the future, especially in periods of more rapid economic growth (Karoly 2004).

The U.S. Bureau of Labor Statistics expects a labor shortage of 5 million to 10 million workers by 2010 (Kinsman 2004). Furthermore,

changes in business organization, management structures, and employment relationships have other implications for the relationship between employers and their employees in more-traditional employment relationships. While shifts in organizational form and the use of nonstandard work arrangements weaken the bonds between employers and their employees . . . many employers increasingly recognize the human capital and knowledge base of their employees as a critical asset. Within this context, the use of high-performance workplace practices that give greater decision-making authority to front-line employees is blurring the traditional distinction between “labor” and “management.” Changing employer-employee relationships will also alter the opportunities and challenges faced by labor unions (Karoly 2004).

Finally, the rapid pace of technological change is expected to propel demand of highly skilled workers who can develop the new technologies and bring them to market, and who can exploit the new technologies in the production of goods and services. Maintaining a highly skilled workforce is also a key component of an American comparative advantage in the world economy. Shifts in organizational forms and the nature of employment relationships, brought about by new technologies and global competition, also favor such high-level cognitive skills as abstract reasoning, problem-

solving, communication, and collaboration, attributes associated with so-called “knowledge work (Karoly 2004).”

In regards to the type of worker, the number of creative professionals, i.e., knowledge-based, was 200,000 in 1900 whereas in 1999 it has increased to 7.6 million of all professionals. In terms of percentage of all employment, this represents .7 percent and 5.7 percent respectively (Lev 2001, page 15). Table 11 outlines in detail *Professional Creative Workers, 1900-99*. Finally, in an Accenture (2004) study, six percent of managers surveyed responded that they thought there was a severe impact on business from the “war” for talent today; while it more than doubled to 13 percent of managers who foresee the “war” as an issue for the future. Table 12 outlines the *Impact of the war for talent*.

The evidence that the theft of shareholder wealth is present is clear. It has become an issue for regulatory agencies; scholars and researchers have proven the connection between intangibles, especially human capital, and the value of the corporation; and necessary state-of-the-art tools to measure the value, and finally, potentially the most important element, the shrinking workforce, have been developed. Many elements outlined are theory, though proven. However, the shrinking workforce is indisputable and potentially crippling to an American corporation in this global market.

CHAPTER 4 - The Significance Of The Theft Of Shareholder Wealth

The theft of shareholder wealth is important because of numerous factors. As the public tirelessly scrutinizes corporate executives and their appetite for excess, greed, and constant pursuit of wealth, the public, which includes not only independent investors but also employees holding stock or stock options, will eventually realize there is a substantial amount of wealth going unclaimed. On March 15, 2005, the Chief Executive Officer of WorldCom was found guilty for numerous counts of fraud, excess, and a breach of fiduciary duty to the shareholders. Currently in the courts, the Board of Directors of Walt Disney is under investigation on how they handled or allowed to be handled the employment agreement of its former President. These two public examples come in the wake of Enron, Arthur Anderson, and Healthcare South, all of which are still expected to arrive in court, addressing numerous counts of fraud. Regardless of whether the corporations are found guilty or not, it is always the shareholder and its employees who pay the legal bills, penalty, fees, and suffer the loss of wealth. These are all issues of the fiscal management of corporations. The intangible assets, such as human capital of a corporation, however, still have vast potential locked up, waiting to be released through the intervention of an innovative corporate executive, shareholder intervention, or regulatory intervention. The primary factors contributing to the significance of the theft of shareholder wealth are ongoing agency problems, poor or misdirected ethics, non-comprehensive regulatory ways and means, a lack of metrics, little attempt to apply metrics, incomplete or inaccurate reports, false assumptions on how to increase shareholder wealth and/or company growth, and a lack of investor confidence.

Misalignment Of Corporate Objectives

A major focus in the current public debate on corporate governance and transparency addresses the alignment of corporate strategy with shareholder interests, and concerns the principles of stewardship and wealth creation (Ingley 2004).

The dominant view of the modern corporation in management literature is that “the exclusive obligation of the corporation is to maximize shareholder return, constrained only by an obligation to obey the law and respect conventional morality (Cragg 2002).” It is further argued that, “the purpose of modern corporate governance is to increase shareholder and economic wealth in a sustainable way, to align the interests of boards, management, shareholders, and to provide timely and accurate information to facilitate accountability to shareholders and other stakeholders (Ingley 2004).”

The publicity surrounding corporate governance and transparency has resulted in calls for shareholders to act more like owners and exercise their rights by voting their proxies, thus taking greater control over the corporation than they have in the past and holding corporate agents to a greater account for performance (Ingley 2004). A 1992 American Law Institute report entitled *Principles of Corporate Governance* was written under the explicit assumption that the purpose of the corporation is

enhancing corporate profit and shareholder gain. The responsibility of a corporate executive . . . is to conduct the business for which they are responsible in accordance with the desire of the owners of the business which will be ‘to make’ as much money as possible while conforming to the basic rules of the society, both those embodied in law and embodied in ethical customs (Cragg 2002).

Empirical results indicate that maximizing corporate growth does not maximize corporate profitability or shareholder wealth. Corporations with moderate growth in both sales and earnings show the highest rates of return and wealth creation for their owners. These results support the warning of Fuller and Jensen about the dangers of conforming to market pressures for growth (Jung 2002).

Related to individual accountability, two interrelated agency problems can be clearly identified, one concerning the specification of objectives and the other concerning agent performance, as well as four resulting costs to the principal.

One is a cost of incompetence (strictly speaking, the costs of an agent's incompetence), which is the cost of the deviation between objectives and outcome arising from an agent's limited competence to interpret objectives, judge situation, and take appropriate actions. The second is a cost of specifications (in effect, the cost of a principal's incompetence), which is the cost of the difference between the satisfaction of a principal's overall objectives and the satisfaction of the objectives specified in the contract. A third is the cost of training, which is the cost of devoting resources to improve an agent's technical competence. Finally, the fourth is the cost of guidance, which is the cost of devoting resources to communicating an understanding of objectives outside the contract specification (Hendry 2002).

It is argued that it is impossible for a corporation to function effectively without "some measure of honesty, cooperation, and trust, and it is impossible to delegate authority to agents without relying to some extent on their loyalty, honesty, and goodwill.

This basic fact of life is recognized in traditional legal conceptions of agency, but is ignored in standard agency theory, which focuses on the consequences of opportunistic self-seeking (Hendry 2002).” According to Kushner, the Responsible Corporate Officer doctrine, “although originally developed in response to misdemeanor prosecutions for public welfare violations, should be recast as a general theory of criminal liability of corporate officers (Kushner 2003).”

Stakeholder theory, however, opens the door to the application of what Charles Taylor describes as the fundamental moral insight of Western civilization, namely, “the universal attribution of moral responsibility.” This means that “in fundamental ethical matters, everyone should receive consideration, and all should be considered in the same way. Within this outlook, one absolute requirement of ethical thinking is that we respect other human agents as subjects of practical reasoning on the same footing as ourselves (Cragg 2002).”

Clarkson argues that stakeholder theory provides “a structure and rationale for understanding and explaining why building ethics into planning and operations is a sound management strategy and why firms with records of ‘ethical’ management might be expected to outperform competitors lacking this focus on the medium or long term measured by conventional financial and market tests of performance (Cragg 2002).”

Clarkson further argues that

not only should managers focus on stakeholders issues, they must do if they are to avoid corporate breakdown and failure. Clarkson distinguishes between primary and secondary stakeholders in this regard. He defines primary stakeholders as those “without whose continuing participation the

corporation cannot survive as a going concern” and points out that “there is a high level of interdependence between the corporation and its primary stakeholder groups.” Secondary stakeholders are defined as “those who influence or affect, or are influenced or affected by, the corporation.” However, secondary stakeholders are not “engaged in transactions with the corporation and are not essential for its survival.” On the other hand, secondary stakeholders “can cause significant damage to a corporation (Cragg 2002).”

Shareholder theory, in turn, defines managers as agents and investors as their principals. As agents, managers have fiduciary duties. Those obligations are ethical in nature. Therefore, shareholder theorists like Milton Friedman conclude that on their account of the matter, “managers have ethical obligations, namely, the obligation to maximize profits. With respect to other stakeholders, however, the only obligation is to think strategically (Cragg 2002).”

Regardless of stakeholder or shareholder theories, ethics still hold a place in business. Goodpaster’s account of business ethics builds on the recognition that moral personality is inalienable.

On the first interpretation of his position, he is proposing that managers do not cease to be moral agents responsible for acting morally when they step into their role of managers. That is to say, their overriding moral obligation is to meet their fiduciary obligations to their principals in a manner that is consistent with the moral obligations that everyone has to treat everyone they interact with as ends and not as means only. On the

second interpretation, Goodpaster may be suggesting that managers are moral agents by proxy; that is, as agents they take on the moral personality or moral character of their principals. This view is subject to severe criticism as our discussion of the first interpretation above implies.

However, it does have the merit of pointing out that investors are also moral agents. Moral agency by its nature constrains the pursuit of pure self-interest. It follows that investors have an obligation to evaluate all their actions in light of their impact on others. Those others, as we have already seen, are by definition the corporation's stakeholders (Cragg 2002).

Global Implications

Globally, the Organisation for Economic Co-operation and Development's *Principles of Corporate Governance* calls for a stronger role for shareholders in a number of important areas,

including executive remuneration and the appointment of board members.

They call on companies to make sure that they have mechanisms to address possible conflicts of interest, to recognize and safeguard the rights of stakeholders and a framework in which internal complaints can be heard, with adequate protection for individual whistleblowers. They stress the responsibilities of auditors to shareholders and the need for institutional investors acting in a fiduciary capacity such as pension funds and collective investment schemes to be transparent and open about how they exercise their ownership rights. And they call on company boards to

be truly accountable to shareholders and to take ultimate responsibility for their firm's adherence to a high standard of corporate behavior and ethics (Organisation for Economic Co-operation and Development 2004).

A study by Accenture (2004) of key organizational capabilities revealed, for example, that 65 percent of companies believed developing effective leadership capabilities was very important while only 8 percent believed their performance indicated that they themselves had done so. Twenty-nine percent said that giving employees authority and ability to execute and act on business insight was very important while only 9 percent thought they did the job very well. Table 13 outlines additional *Key Organizational Capabilities*.

Corporate managers need to abandon the habit of blindly increasing company size and investors need to consider the drawbacks of diseconomies of scale. Managers need to make a fundamental shift in their strategic orientation from “growth now, profitability later” to “profitable growth now.” That is, growth should not be the input to strategic planning but the outcome of a sound investment strategy that is geared to accepting value-creating projects (Jung 2002).

Reporting The Full Financial Picture

On the reporting front, researchers can empirically demonstrate the unduly high uncertainty discount that investors apply to Research and Development-intensive companies because Research and Development expenditures are reported in corporate financial statements. Most other types of investments in intangibles are usually not fleshed out publicly or even systematically tracked within a company. Nevertheless, it

makes sense that such investments are also subject to the undervaluation syndrome, particularly because they are even less visible and less conspicuously linked to positive outcomes than Research and Development spending (Lev 2004)

Unfortunately, the Federal Accounting Standard Board removed a project addressing the need to disclosure further intangible assets in January 2004. The objective of the project was to establish standards that will improve disclosure of information about intangible assets that are not traditionally recognized in financial statements. Those unrecognized intangible assets include assets that are developed internally and those that are acquired and written off immediately (Federal Accounting Standards Board 2004).

Generally Accepted Accounting Practices [currently] treats practically all internally generated intangibles not as investments but as costs that must be immediately expensed, thereby seriously distorting enterprise profitability and asset values. Furthermore, Generally Accepted Accounting Practices does not require firms to disclose any meaningful information about intangible investments, except for aggregate Research and Development expenditures, lumping the rest of them in with general expenses. This keeps investors in the dark about how companies allocate Research and Development budgets to basic research, product development, and process improvements, brand enhancement, employee training, etc., (Lev 2004).

Much of the squandered value that intangible assets could generate can be recovered by both companies and investors if firms made more formal efforts to compile and report the information relating to intangibles

that currently falls through the cracks of conventional accounting.

Specifically, such efforts need to be aimed at producing two vital streams of information, one involving productivity, and the other asset values (Lev 2004)

The high cost of capital prevents such companies from raising funds in capital markets. It is a serious impediment to the multitude of smaller, younger, and far less profitable enterprises that are in dire need of affordable financing (Lev 2004). The benefits intangible investments yield are the only means companies can use to escape intensifying competitive pressures. Accounting systems were designed for an industrial era in which physical and financial assets were paramount (Mayo 1999), yet the information deficiencies pertaining to intangibles result in serious share price distortions and misallocations of corporate resources, effectively handicapping performance and growth (Lev 2004)

Where Did All The Workers Go?

As human capital becomes more important, corporations are also losing control of it for two reasons.

First, the easier access to financing has increased employees' outside options. Second, the opening of world trade created the space for many independent suppliers. This increasing rate of employee turnover across many economic sectors testifies to the deteriorating bonds between employers and employees. The enormous loss from employee turnover is demonstrated by the findings that 71 percent of the firms in the Inc. 500

list were established by persons who replicated or modified innovations developed within their former employers (Lev 2001, page 13).

Despite continual downsizing and retirement, older workers will be competing for too few jobs at the top of the pyramid – and the jobs available will likely require a continually evolving set of skills. At the other end of the spectrum, a shortage of younger workers means they can sell themselves to the highest bidder. Despite the recent economic correction in the United States, that creates havoc for recruitment and retention strategies, driving up costs and threatening future competitiveness and profitability. As wage and benefit costs rise, shareholder returns may fall (Kay 2002, page xxxiii).

The significance of the theft of shareholder wealth falls into three broad categories: first, the misalignment of the corporation's objectives to shareholder wealth; second, the global integrity of the American corporation, coupled with potential damage from a shrinking workforce; third, the continued underreporting and documentation of the bulk of corporation's value when it is in intangibles. The issue must be addressed before the American corporation loses its competitive edge.

CHAPTER 5 – Recommendations And Conclusions

This manuscript focused on the human capital of the corporation. Its underlying premise was to ask what prevents the enforcement of fiduciary duty upon agents of a corporation to return maximal shareholder wealth through investment in human capital. It is clear that this problem has been developing for some time, and only as we have entered a new knowledge era is this problem causing more issues for corporations and shareholders. Internally, through intervention via the Board of Directors, executives or senior management, as well as all the other legal agents of a corporation, the problem can be minimized or eliminated. A simple solution would be to invest in human capital as much money and effort as has been invested in any product or service being offered by a corporation. Alternatively, shareholders have the option to demand human capital reform from the Board of Directors, et. al. Shareholders may appeal to the Board for an investment in the intangibles, specifically human capital, or they may bring the corporation to court through a derivative lawsuit, or invest their money into corporations that recognize the value of human capital, effectively supporting the competition. Externally, the regulatory agencies have the ways and means of not necessarily forcing the investment in human capital per se, but instead requiring the necessary reporting and public disclosure on what the corporation is doing, in order to increase the value of the intangible assets. Furthermore, as this manuscript is solely focused on corporate agents, only those ways and means of improving shareholder wealth from the inside out will be discussed.

Putting People First

Pfeffer (1998, pages 293-299) asks the question

What does it mean to put people first, recognizing and acting on the fact that in today's world . . . almost every other source of organizational success – technology, financial structure, and competitive strategy – can be imitated in an amazingly short period of time. It means, first of all, publicly and repeatedly stating the primacy and importance of people to organizational success. Second, putting people first means fixing the firm's language to ensure consistent use of terminology that does not convey disrespect or disdain of its people. Third, leaders and organizations who believe that putting their people first is important actually act on that belief in numerous ways. Another way organizations signal their commitment to their people is through their training expenditures. Fourth, putting people first means gathering measurements so the organization can assess how well it is doing and being willing to act on those measurements. Fifth, and perhaps most importantly, putting people first entails ensuring that those in leadership positions have people-oriented values and manage in ways consistent with building high performance work environments. Finally, putting people first entails recognizing the importance of people – all of a company's people in all organizations – to organizational success.

Lev (2004) indicates, “companies need to generate better information about their investments in intangibles and the benefits that flow from them. Doing so will both improve managerial decisions and give investors a sharper picture of the company and its performance, which will lead to more accurate valuations and lower the cost of capital.”

He goes on to say, “various research projects demonstrate that improved disclosure – particularly about innovation-related intangibles – is associated with reduced stock price volatility, narrower bid-ask spreads, and higher stock prices.”

There are numerous methods and schools of thought on how to address this issue. Many of them are in a fundamental shift of strategic thought and planning. For example, Ulrich (2004) outlines that there are 11 capabilities identified that well managed companies possess and that all companies should acknowledge and work towards. They are:

- 1) Talent: We are good at attracting, motivating, and retaining competent and committed people.
- 2) Speed: We are good at making important changes rapidly.
- 3) Shared Mind-Set and Coherent Brand Identification: We are good at ensuring that employees and customers have positive and consistent images of and experiences with our organization.
- 4) Accountability: We are good at obtaining high performance from employees.
- 5) Collaboration: We are good at working across boundaries to ensure both efficiency and leverage.
- 6) Learning: We are good at generating and generalizing ideas with impact.
- 7) Leadership: We are good at embedding leaders throughout the organization.
- 8) Customer Connectivity: We are good at building enduring relationships of trust with targeted customers.
- 9) Strategic Unity: We are good at articulating and sharing a strategic point of view.

10) Innovation: We are good at doing something new in both content and process.

11) Efficiency: We are good at managing costs.

Another school of thought is that the fundamental human capital practices make up the foundation of High Performance Management Systems. According to Pfeffer (1998, pages 301-302), those practices provide competitive advantage for two interrelated reasons.

First, they are difficult to imitate. Second, because they are positively related to organizational learning and skill development, innovation, customer service, labor productivity, costs, and organizational flexibility to adapt to new competitive conditions and threats. If a set of management practices are at once difficult to imitate and positively related to numerous sources of competitive success, the result is outstanding levels of profitability, achieved over a long time. Utilizing this approach results in “profitability and success that is robust in that it can succeed: across changes in leadership, across changes in the political environment, across changes in technology, across changes in economic circumstances, across different cultures, and across changes in the competitive environment (Pfeffer 1998, pages 301-302).”

The strategic alignment process must commence with an understanding of the corporation’s value chain – a clear, corporate idea of where the value lays and how it is made. In fact, Robert Kaplan and David Norton have defined this as a “strategy map (Becker 2001, pages 19).” Becker (2001, page 19) outlines, “a key distinguishing characteristic of a High-Performance Work System is not just the adoption of appropriate

Human Resources policies and practices such as employee acquisition, development, compensation, and performance management, but also the way in which these practices are deployed.”

“Alignment with strategy is what creates value for an intangible asset,” said David P. Norton, president of the Balanced Scorecard Collaborative in Lincoln, Mass. The higher an intangible asset’s strategic readiness, “the more aligned it is with the company’s strategy and the faster it can be converted into a tangible asset, which can then be turned into something liquid (read: earnings) (Gary 2003).”

One tactic to maximize the organization’s effectiveness and efficiency is “policy deployment.” Many employees are either unaware of the company’s business goals or misinterpret them. E-learning, for example, provides an excellent tool to communicate company strategy and to provide practical examples of how decisions on the shop floor or in the back office can support the strategy. E-learning can help explain executive-level strategies clearly and consistently to both new and long-term employees, ensuring that each individual is cognizant of his role in . . . the plan. E-learning provides a unique opportunity to familiarize the employee with these areas of the business. This deeper understanding will pay off in more effective communication between the two groups but, more importantly, will help the employees make more practical business process improvement suggestions (Summers 2004).

Another tactic is to pursue “continuous improvement.” Corporations pursue ways to eliminate waste through unnecessary steps. This is accomplished via a *Kaizen* event, “a

staged attack on a particular process to develop ideas for improvement or waste elimination. When employees are not familiar with processes outside their area of expertise, they tend to optimize the performance of their own group or department, rather than optimizing the company's performance as a whole (Summers 2004).”

Regarding leadership, the ‘Human Performance Leaders’ share characteristics of high performance businesses. These leaders exhibit the following characteristics (Accenture 2004):

- Leaders have posted stronger financial performance than non-leaders over the short term and long term.
- Leaders are more likely to be ramping up to grow their business in the coming year.
- On average, leaders consider all the key organizational capabilities much more important to addressing critical marketplace challenges, and believe they are doing much better in developing each capability, than non-leaders do.
- Leaders have high-performance workforces.
- Leaders tend to more highly value, and perform better in, human resources and training.

Accenture (2004) has identified six distinct practices – those in which technology and measurement often play a key role – that companies can employ to dramatically improve the performance of their workforce and the overall contribution the workforce makes to business performance.

1. Institute a formal process for talent management, supported by appropriate technologies that enable objective assessment of employees, skills, and

capabilities, as well as quick and easy identification of the best candidates for open positions.

2. Proactively develop the capabilities of the organization to foster innovation and manage change so new strategic initiatives can be implemented more effectively and the organization can be better positioned to manage through the inevitable “boom and bust” cycles.
3. Complement traditional Human Resources competencies with technology, financial and strategy expertise that can boost the business value of the Human Resources function.
4. Create a communicative and participative culture that fosters loyalty and a high level of engagement among employees at all levels of the company.
5. Identify the critical linkages between Human Resources and training programs with specific business outcomes to ensure that the programs are aligned with and meeting the needs of the business at large.
6. Use innovative model – including shared services and outsourcing – to streamline Human Resources and training operations and, subsequently, provide better Human Resources and training services at a lower cost.

Outlined in the book, *Why the Bottom Line Isn't: How to Build Value Through People and Organization* (Smallwood 2003, page 260-263) are 15 tips for creating intangible value:

- 1) Do an intangible audit.
- 2) Lower expectations and deliver more.
- 3) Start small.

- 4) Simplify your message, link them to your strategy, and then keep repeating them.
- 5) Create a shared direction.
- 6) Invest in technical excellence.
- 7) Surround yourself with talent.
- 8) Be rigorous and unforgiving of poor performers.
- 9) Constantly praise and express gratitude to the employees.
- 10) See patterns in events.
- 11) Think about your organization from the outside in.
- 12) Instill personal ownership and responsibility within your organization.
- 13) Learn constantly by taking risks, experimenting, and reevaluating repeatedly.
- 14) Collaborate frequently.
- 15) Build leadership brands.

Based on a study of three Watson Wyatt surveys Kay and Pfau (2002, pages xxiii-xxix) concluded that corporations seeking to maximize shareholder wealth must concentrate on:

- 1) Achieving recruiting and retention excellence
 - a. Approach recruiting and retention as mission-critical
 - b. Hire people who can hit the ground running
 - c. Make sure your company is known as a great place to work
 - d. Involve employees in the hiring process
 - e. Focus on the basics. People are more alike than different.
- 2) Creating a total reward and accountability orientation

- a. Link rewards to performance
 - b. Demand that CEO's own a significant stake in the company
 - c. Offer significant stock-based incentives across the board
 - d. Synchronize pay
 - e. Creating opportunities for all employees to soar
- 3) Establishing a collegial, flexible workplace
- a. Understand that employee satisfaction is critical to any business goal
 - b. Minimizing status distinctions
 - c. Do not underestimate the crucial importance of senior leadership
 - d. Learn how to manage change
 - e. Don't assume workers no longer care about job security
 - f. Be cautious about developmental training
- 4) Opening up communication between management and employees
- a. Make communication open and candid
 - b. Ask for employee feedback only if you intend to act on it
 - c. Be careful in implementing 360-degree feedback
- 5) Implementing focused Human Resources technology.

Take Them To Court

If legal corporate agents do not voluntarily pursue shareholder wealth through human capital investment, then shareholders have legal means of pursuing change.

There are two types of lawsuits the shareholders may pursue: *personal or class action* and *derivative actions*. In personal or class actions, shareholders may seek personal remedy against the company. In derivative action lawsuits, shareholders may

seek remedy for the corporation against corporate agents for a breach of their fiduciary responsibilities, arguing the agents are not pursuing all of the wealth creating options available (Urtiaga 2004). According to Urtiaga (2004),

the regulation of derivative actions can be understood as an attempt to facilitate the filing of meritorious actions, as a means to improve corporate governance and transparency. First, there exists a requirement for the corporation to pay the legal fees of the successful plaintiffs. The second requirement is the requirement of demand upon the board to take proceedings on behalf of the corporation.

This, of course, would not be the preferred means, but is, nonetheless, an available option.

What It All Means

As outlined, these are only a few of the innovative strategies to maximize human capital, and they are only the beginning when it comes to the ways and means of investing in human capital. Additional studies are needed. Furthermore, the metrics discussed herein are only a few of the more notable examples; as greater emphasis is placed on intangibles and human capital, more state-of-the art metrics will undoubtedly be developed.

For American corporations to continue to lead the economy, corporate agents must be willing to pursue new ways and means, see the corporation for what it is – the sum of its people- and have the courage to pursue change. Corporate agents must acknowledge where the value is within the corporation, business schools must educate future corporate agents in such value, and finally, those capable of instigating change,

must remove themselves from the “group think” mentality and pursue new and innovative ideas.

Dave Spence of Boise Cascade practices people management and best states, “capital and machinery make it possible – people make it happen (Pfeffer 304-5).”

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Appendix

Legal Terminology

To provide a legal foundation from to work are a few terms that will be discussed throughout this manuscript and their definitions (Gifis 1991):

- *Agency* is defined as a “relation in which one person, the agent, acts on behalf of another with the authority, the principal; “a fiduciary relation which results from the manifestation of consent by one person that another shall act on the former’s behalf and subject to this control, and consent by the other so act.” The acts of an agent will be binding on his principal.
- *Apparent Authority* is defined as “a doctrine involving the accountability of a principal for the acts of his agent “which operates to make a principal liable for operative words spoken by an agent in the course of a transaction with another to whom the principal has represented that the agent has authority . . . “ It refers to that situation created when a principal such as a corporation “manifests to a third person that an ‘officer’ or ‘agent’ may act in its behalf, and such third person in good faith believes that such ‘authority’ exists. In such as case, lack of actual authority, express or implied is no defense.
- *Corporation* is defined as an association of shareholders created under law and regarded as an artificial person by courts, “having a legal entity entirely separate and distinct from the individuals who compose it, with the capacity of continuous existence or succession, and having the capacity as such legal entity, of taking, holding and conveying property, suing and being sued, and exercising such other powers as may be conferred on it by law, just as a natural person. Corporations are subject to regulation by the state of incorporation and by the jurisdictions in which they carry on their business. State laws in some jurisdictions give corporate board of directors and officers more freedom from stockholder consent and scrutiny than other states and thereby induce many corporations to form within their jurisdictions.
- *Derivative Action* is defined as an action based upon a primary right of a corporation, but asserted on its behalf by the stockholder because of the corporation’s failure, deliberate or otherwise, to act upon the primary right. Such suits are the only civil remedy a stockholder has for breach of a fiduciary duty on the part of those entrusted with the management and direction of their corporation. Recovery in a derivative action generally inures to the benefit of the corporation because the action asserts a corporate rather than an individual right.

- *Fiduciary* is defined as “a person having a [legal] duty, created by his undertaking, to act primarily for the benefit of another in matters connected with his undertaking; in the nature of a position of trust or holding confidence.

- *Reasonable Man (Person)* is defined as a hypothetical person who exercises “those qualities of attention, knowledge, intelligence, and judgment which society requires of its members for the protection of their own interests and the interests of others. A test used to determine whether or not one person was negligent towards another. Negligence will exist upon a failure to do “something which a reasonable man, guided by those consideration which ordinarily regulate the conduct of human affairs, would do, or [the doing of] something which a reasonable and prudent person would not do.

Table 1

Getting the Measure of Intangibles - How Important are Intangible Assets To your company?

Primary source of shareholder wealth creation	49%
Roughly equal to tangible assets for shareholder wealth creation	26%
Have intangible assets but rely primarily on tangible assets	22%
Rely primarily on tangible assets for shareholder wealth creation	3%

Does your company measure the performance of its intangible assets?

Yes, we have a robust system	5%
We apply some measures but we don't have an organized system	20%
We apply some measures but they're mainly informal or qualitative	41%
No, we don't measure the performance of intangible assets	33%

From "Getting the measure of intangibles [Electronic version]," March 2004, *Treasury and Risk Management*, 8.

Table 2

How Will Companies Improve Performance Beyond Cutting Costs?

Focus on specific strategies, partnerships and business growth opportunities to increase sales	17%
Provide employees with training, seminars, and other educational resources	13%
Motivate and recognize employees	11%
Introduce new products and services to the marketplace	8%
Implement the latest technology to streamline operations	7%
Hire new employees and concentrate on recruitment efforts	7%
Improve internal communications	6%
Improve customer service and personal goals	4%

From “What steps will companies take to improve their performance [Electronic version],” *Human Resource Department Management Report*, February 2005, 9.

Table 3

How HR rates management communication

Very satisfactory job	25%
Somewhat satisfactory job	58%
Not very satisfactory job	14%
Not at all satisfactory	2%

From “HRDMR new brief [Electronic version],” 2004, *Human Resource Department Management Report*, 8.

Table 4

What do you understand by the term “intangibles,” when used in a business context?

It refers to R and D, brand, intellectual property and goodwill only as defined by relevant accounting standards boards.	50%
It refers to all assets that cannot be valued with any certainty but which are place on the balance sheet.	35%
I don't have a clear understanding of the term “intangibles”	3%
Other (human capital, management team, values outside the ‘classical’ balance, sheet, etc.)	13%

From “Intangible assets and future value [Electronic version],” 2003, *Accenture*, Retrieved March 9, 2005 from http://www.accenture.com/xdoc/en/services/sba/hotidea/fva_summary.pdf

Table 5

Top Ten Non-financial Variables Considered by Financial Analysts

- 1) Execution of corporate strategy
- 2) Management credibility
- 3) Quality of corporate strategy
- 4) Innovation
- 5) Ability to attract and retain talented people
- 6) Market share
- 7) Management expertise
- 8) Alignment of compensation with shareholders' interests
- 9) Research leadership
- 10) Quality of major business processes

From *The HR scorecard: linking people, strategy, and performance* by Brian Becker, Mark Huselid, and Dave Ulrich, 2001, Boston: Harvard Business School Press, 9.

Table 6

Saratoga Institute Human Capital Benchmarks

ORGANIZATIONAL EFFECTIVENESS	EMPLOYEE RELATIONS
Revenue factor	HRIS
Expense factor	HR management
Income factor	Legal
Human capital value added	
Human capital ROI	SEPARATIONS
Human economic value-added	Separations rate by category
Outsourcing	Exempt
Expense percent	Nonexempt
Management ratio	Management
Management investment factor	Professionals
Average tenure	Sales
Headcount percent – contingent	Office and clerical
FTE percent by category	Operatives
Contingent on payroll	Total
Contingent off payroll	Voluntary separation rate
Contingent total	Involuntary separation rate
Management	
Professionals	STAFFING
Sales	Accession rate
Office and clerical operatives	Add rate
	Replacement rate
HUMAN RESOURCE STRUCTURE	Career path ratio
HR expense percent	Cost per hire
HR FTE ratio	Cost per hire breakdown
HR exempt percent	Advertising
HR FTE investment factor	Agency
HR headcount investment factor	Referral bonuses
HR outsourcing percent	Travel
HR consulting percent	Relocation
HR compensation expense percent	Recruiter cost
HR employee cost factor	Time to fill
HR total employee cost factor	Time to start
HR separation rate	Offer acceptance rate
HR structure breakdown	Sign-on bonus percent
Administration	Manager
Benefits	Executive
Compensation	Sign-on bonus factor
	Manager
	Executive

COMPENSATION

Compensation revenue percent
 Total compensation revenue percent
 Total labor cost revenue percent
 Compensation expense percent
 Total compensation expense percent
 Total labor cost expense percent
 Contingent cost revenue percent
 Contingent cost expense
 Percent – total compensation
 Percent – by category
 Executives
 Managers
 Staff
 Variable
 Contingent on payroll
 Contingent off payroll
 Contingent total employee cost
 Factor – by category
 Regular employees
 Workforce employees
 Executives
 Managers
 Staff
 Total employee cost factor
 Total labor cost factor
 Contingent cost factor

BENEFITS

Benefit revenue percent
 Benefit expense percent
 Benefit compensation percent
 Benefit factor
 Health care factor
 Workers' compensation factor
 Benefit cost breakdown
 Legally required payments
 Retirement and savings plan
 Life insurance and death
 Medical and medically related
 payments for time not worked
 Miscellaneous benefits

TRAINING AND DEVELOPMENT

Employees trained percent
 Training cost factor
 Training cost percent – total
 Training cost percent – external
 Training cost percent – internal
 Training cost HR expense percent
 Training compensation percent –
 excluding trainee pay and benefits
 Training compensation percent –
 including trainee pay and benefits
 Training headcount investment factor
 Training FTE investment factor –
 including trainee pay and benefits
 Training staff ratio
 Headcount training factor
 FTE training factor
 Training cost per hour – excluding
 trainee pay and benefits
 Training cost per hour – including
 trainee pay and benefits
 Training hours percent – internal staff
 Training hours percent – external staff.

From *How to measure human resources management* by Barbara Davison and Jac Fitzenz, 2002, New York: McGraw-Hill, 22-23.

Table 7

Watson Wyatt's Human Capital Index- Links Between Human Capital Practices and Value Creations

	Impact on Market Value (%)
RECRUITING AND RETENTION EXCELLENCE	7.9%
Company has low voluntary turnover of managers/professionals	1.7
Company has low voluntary turnover of employees in general	1.5
Company emphasizes job security	1.4
Formal recruiting strategy exists for critical-skill employees	.6
Recruiting efforts are aligned with the business plan	.5
Employees have input on hiring decisions	.5
Company has established reputation as a desirable place to work	.5
Systematic new-hire orientation exists	.4
Hourly/clerical new hires are well equipped to perform duties	.4
Professional new hires are well equipped to perform duties	.4
TOTAL REWARDS AND ACCOUNTABILITY	16.5%
Health benefits are important for recruiting and retention	2.8
High percentage of company stock owned by employees	1.3
Defined contribution and defined benefits plans, combined, important for recruiting and retention	1.3
High percentage of company stock owned by senior managers	1.2
Pay is linked to company's business strategy	1.1
High percentage of employees eligible for stock options	1.0
Company promotes most competent employees	.9
High percentage of employees participate in incentive/profit- sharing plans	.9
Defined benefit plan important for recruiting and retention	.9
Employees have choice regarding benefits	.8
Defined contribution plan important for recruiting and retention	.8
Top performers receive better pay than average performers	.8
Company positions benefits above the market	.7
Company helps poor performers improve	.7
Company positions pay above the market	.7
Company terminates employees who continue to perform poorly	.6
COLLEGIAL, FLEXIBLE WORKPLACE	9.0%
Company shows flexibility in work arrangements	3.5
Company has high employee satisfaction	1.3
Trust in senior leadership is actively engendered	1.2
Managers demonstrate company's values	1.1
Company culture encourages teamwork and cooperation	.5

Company avoids using titles to designate status and authority	.5
Company avoids varying perquisites by position	.5
Company avoids varying office space by position	.4
COMMUNICATIONS INTEGRITY	7.1%
Employees have easy access to technologies for communication	4.2
Employees at all levels give ideas and suggestions to senior management	.7
Company shares business plans and goals with employee	.6
High percentage of workforce participates in opinion surveys	.6
Company shares financial information with employees	.5
Company takes action on employee survey feedback	.5
FOCUSED HR SERVICE TECHNOLOGIES	6.5%
Improving service in employees/managers is a key goal in implementing HR service technology	2.3
Reducing cost is a key goal in implementing HR service technology	2.3
Increasing transaction accuracy/integrity is a key goal in implementing HR service technology	1.9
PRUDENT USE OF RESOURCES	-33.9%
Enhancing communication is a key goal in implementing HR service technology	-7.7
Cultural change is a key goal in implementing HR service technology	-6.6
Employees have opportunity to evaluate supervisors	-5.7
Employees have opportunity to evaluate peers	-4.9
Employees have access to training needed for career advancement	-5.6
Training programs maintained even in difficult economic circumstances	-3.4

From *The human capital edge: 21 people management practices your company must implement (or avoid) to maximize shareholder value* by Ira T Kay and Bruce Pfau, 2002, New York: McGraw-Hill, xviii-xxii.

Table 8

Key Links Between Human Capital and Global Shareholder Value Creation

Recruiting Excellence	10.1%
Clear Rewards and Accountability	9.2%
Collegial, Flexible Workplace	7.8%
Communications Integrity	4.0%
Prudent Use of Resources	-10%

From “Human capital index: linking human capital and shareholder value [Electronic version],” *Watson Wyatt*, Retrieved February 25, 2005 from www.watsonwyatt.com/research

Table 9

Probability of an initial public offering firm surviving five years

IPS surviving after five years with one standard deviation above the mean based upon HR value	79%
IPS surviving after five years with one standard deviation below the mean based upon HR value	60%
IPS surviving after five years with one standard deviation above the mean based upon Rewards	87%
IPS surviving after five years with one standard deviation below the mean based upon Rewards	45%

From *The human equation: building profits by putting people first* by Jeffrey Pfeffer, 1998, Boston: Harvard Business School Press, 37.

Table 10

Comparison of High and Low HR Management Quality

	Bottom 10%	Top 10%
Human Resources Practices		
Number of qualified applicants per position	8.24	36.55
Percentage hired based on a validated selection test	4.26	29.67
Percentage of jobs filled from within	34.9	61.46
Percentage in a formal HR plan including recruitment, development, and succession	4.79	46.72
Number of hours of training of new employees (less than 1 year)	35.02	116.87
Number of hours of training for experienced employees	13.4	72
Percentage of employees receiving a regular performance Appraisal	41.31	95.17
Percentage of workforce whose merit increase or incentive pay is tied to performance	23.36	87.27
Percentage of workforce who received performance feedback from multiple sources	3.9	51.67
Target percentile for total compensation (market rate=50%)	43.03	58.67
Percentage of the workforce eligible for incentive pay	27.83	83.56
Percentage of difference in incentive pay between a low-performing and high performing employee	3.62	6.21
Percentage of the workforce routinely working in a self-managed, cross-functional, or project team	10.64	42.28
Percentage of HR budget spent on outsourced activities	13.46	26.24
Number of employees per HR professional	253.88	139.51
Percentage of the eligible workforce covered by a union Contract	30	8.98
Human Resources Outcomes (1="not at all", 6 = "to a very great extent")		
Extent to which strategy is clearly articulated and well understood throughout the firm	3.4	4.21
Extent to which the average employee understands how his or her job contributes to the firm's success	2.8	4
Extent to which senior management sees employees as a source of value creation versus a cost to be minimized	3.31	4.21
Extent to which the executive leadership team is visionary	3.02	4.33
Extent to which the firm attempts to provide job security, even if confronted with declining financial performance	2.71	4.11

Extent to which the firm's decision-making style can be described as participative	3.02	3.81
Extent to which the firm's HR professionals are generally perceived to be administrative experts	3.76	4.56
Extent to which the firm's HR professionals are generally perceived to be employee champions	3.69	4.4
Extent to which the firm's HR professionals are generally perceived to be agents for change	3.31	4.12
Extent to which the firm's HR professionals are generally perceived to be business partners	3.19	4.3
Extent to which line managers generally believe that effective diversity management is a business imperative	2.45	3.65
Extent to which top management shows commitment to and leadership in knowledge share	2.99	4.05
Extent to which the firm has developed and communicated measures of financial performance	3.38	4.63
Extent to which the firm has developed and communicated measures of customer reactions	3.02	4.27
Extent to which the firm has developed and communicated measures of business processes	3.09	4.13
Extent to which the firm has developed and communicated measures of learning and growth	2.26	3.12
Firm Performance		
Employee turnover	34.09	20.87
Sales per employee	\$158,101	\$617,576
Market value-to-book value	3.64	11.06

From *The HR scorecard: linking people, strategy, and performance* by Brian Becker, Mark Huselid, and Dave Ulrich, 2001, Boston: Harvard Business School Press, 16-17.

Table 11

Professional Creative Workers, 1900-99

Year	Professional Creative Workers (millions)	Proportion of all employment (percent)
1999	7.6	5.7
1990	5.6	4.7
1980	3.7	3.8
1970	2.6	3.3
1960	1.6	2.3
1950	1.1	1.9
1900	.2	.7

From “Sharpening the Intangibles Edge [Electronic version],” by Baruch Lev, June 2004, *Harvard Business Review*, 15.

Table 12

Impact of the war for Talent

	Today (%)	Future (%)
1 – No Impact	18	10
2	28	17
3	32	33
4	17	28
5 – Severe Impact	6	13

From “The high performance workforce study – 2004: Executive Summary [Electronic version],” 2004, *Accenture*, Retrieved March 9, 2005 from http://www.accenture.com/xdoc/en/services/hp/research/hp_study_2004_exec.pdf

Table 13

Key Organizational Capabilities

	Rating Capability Very Important (%)	Rating their performance is this area very well (%)
Developing effective leadership capabilities	65	8
Creating an organization that adapts to change	49	8
Engagement and aligning multiple stakeholders	43	14
Sensing shifts in the business environment before competitors	44	9
Generating insights into how environmental shifts affect the business	37	11
Managing large-scale change	34	10
Emphasizing workforces directly related to core competence	30	11
Giving employees authority and ability to execute and act on business insights	29	9
Encouraging and facilitating experimentation and innovation	27	8

From “The high performance workforce study – 2004: Executive Summary [Electronic version],” 2004, *Accenture*, Retrieved March 9, 2005 from http://www.accenture.com/xdoc/en/services/hp/research/hp_study_2004_exec.pdf