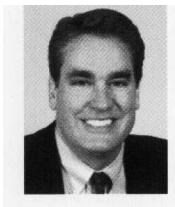


Addressing Structural Issues in Executive Incentive Plan Design



Executive Incentive
Plan Design

Companies with revenues in the range of \$5 billion to \$10 billion typically spend about \$100 million for executive incentives.¹ Considering this level of expense, it is prudent to examine how well incentive plans work by subjecting them to some basic cost/benefit comparisons.

Executive management incentives, of course, are significant. After all, executives are the key players who drive business results. A reasonable test for their incentive plans would be to ask:

- ▶ Does the incentive plan encourage management to make decisions that serve shareholder interests in the long run?
- ▶ Does the plan connect with tangible business results? That is, does it relate to operating performance that one can influence in one to three years?

Companies whose incentive programs do not accomplish these goals ought to revisit plan design. The sheer expense and time involved in creating and maintaining incentive plans dictate that they contribute to business success. Incentive plans that don't actively encourage value creation are nothing more than a particularly expensive way to meet other objectives for overall pay – assembling a competitive total pay package, for example, or rewarding advancement. These are reasonable goals within an overall structure of rewards for management, but they are very different from the goal of encouraging great performance in one's present role.

Unfortunately, today's incentive plans usually do not pay executives for their or their team's performance. The bulk of incentive pay is not related to the performance of the executives receiving it. Instead, it is driven by aspects of performance, target setting, measurement or stock valuation that are outside of their control.

Towers Perrin's statistical simulations indicate that typical management teams receive incentive pay driven about 20 percent by their own performance and about 80 percent by factors outside of their control. These results are based on a simulation of incentive rewards for a typical executive with a modal incentive structure of annual incentive (based 50-50 on corporate and business unit results) and stock option grants.²

So, of the \$100 million spent by a typical big company, perhaps \$20 million is incentive pay in the cause-and-effect sense implied by the term "incentive." The other \$80 million – from the viewpoint of most recipients – is pay based on the actions of others or upon market factors they cannot affect.

The \$100 million price tag is enough to get the attention of most companies. Corporate expenditures of that size, ones with startlingly unfavorable cost/benefit comparisons, are costs that tend to go away. Not true with incentives. For a variety of reasons, companies have too much at stake in them – and keeping valuable executives who expect incentive pay is paramount.

Unfortunately, the poor "line of sight" inherent in most executive incentive structures is only the beginning of the problem. The following structural problems with executive incentives are prevalent:

- ▶ Most companies overuse stock options and stock as incentive vehicles for management. This results in heavy economic costs to shareholders while delivering only marginal and vague incentive effects.
- ▶ Some incentives are based on business goals (operating incentives) rather than on the stock price (stock-based incentives). When designing operating

incentives, many companies rely upon flawed or incomplete methods for measuring financial performance. This results in various biases that pose clear risks of reducing company performance over time.

- ▶ The budget process at most companies, often used to set business performance targets, can subvert the hoped-for effects of incentive plans. To quote a 2001 *Harvard Business Review* article, "The corporate budgeting process is a joke, and everyone knows it."³
- ▶ Other aspects of plan design, like award ranges, caps, floors, weightings on various goals and the degree of "line of sight" in incentive plans, often combine in pernicious ways. They can render incentive plans irrelevant, unfair and counterproductive. These effects tend to be an inadvertent result of many plan design choices, and they are often concealed within a complex incentive structure.
- ▶ Executives have little stake in long-term results at the business-unit level (i.e., at the group, division or subsidiary level rather than at corporate). This is a big deal; most of the value of corporations – and most business decisions one might hope to affect with incentive plans – are found in their business units. A detailed discussion of each issue follows, along with a range of solutions.

Issue No. 1 – Overuse of Options and Stock as Incentive Vehicles

Many companies appear to believe that simply by issuing incentive claims such as options – which correlate with shareholder outcomes in terms of gain – they have succeeded in creating incentives that actively encourage the creation of value. But stock does not come with instructions on how to create value and neither do stock options. Even for top officers of public companies, there are serious questions about whether stock-based incentives provide a clear incentive to create value. Why? For one thing, during the one- to three-year term that matters greatly to incentive plan

participants, stock prices fluctuate for reasons mostly unrelated to company performance. Typical movement in exogenous factors like corporate costs of capital – and in very long-run expectations for industry growth – tends to swamp the effects of near-term variation in company results.

For example, during the five-year-or-so period during which a typical stock option is held, stock prices are driven, at best, only one-half by business results. This is a general finding from a variety of statistical tests. The explanatory power of most financial measures – including the more complete value-based variety – trends around 50 percent at best over a five-year period. That leaves 50 percent or more of the variability in stock prices – and in gains on stock-based incentives – unrelated to the financial results actually delivered by management.⁴

Towers Perrin has conducted tests incorporating modest foresight to address the asymmetric information held by management, its proactive role and the anticipatory nature of stock valuation. These approaches improve results only modestly, continuing to suggest that most stock-based incentive costs go out the door based upon factors unrelated to the financial results delivered to date by management. In periods of one to three years (highly relevant ones from an incentive viewpoint), stock-based incentive gains are essentially a crapshoot.

Here is a practical example of the “unpredictability” issue. One method used commonly by executives to project effects of financial performance upon the share price is to take an earnings per share (EPS) projection and multiply it by the current price to earnings (P/E) ratio. In fact, P/E ratios are so variable that this method explains less than 50 percent of stock price movement in a five-year period. Management’s role is to create shareholder value in the long run, typically by making business decisions that have financial results in a few years. The long-term incentive pay, on the other hand,

is driven mainly by other factors.

This does not mean that there is anything wrong with the stock market. In 10 years or more, stock gains line up rather consistently with cumulative financial results. Stock prices reflect other valuation drivers with remarkable efficiency. The stock market, however, cannot be expected to administer management rewards with the degree of timeliness, precision or reliability implied by the term “incentive.”

Unfortunately, most companies are asking the stock market to do just that. Given the mix of incentive pay at most companies, stock and option grants provide more potential reward (for most executives and far more for top officers) than other incentives, according to Towers Perrin’s executive compensation databases and annual incentive design survey.

Stock and options are complex financial instruments whose valuation is a specialized science and pricing an uncertain matter, to say the least. This raises some additional problems for the stock market’s central role in delivering management rewards:

- ▶ To function as incentives, options grants would have to *convey something about what executives should do* in order to receive an incentive payment. But they do not; stock options are silent on the critical matter of expected performance or desired actions.
- ▶ Options might work well as incentives if most executives had a detailed understanding of how various business decisions are likely to translate into financial results and stock value. But outside of the finance function at a company, few executives have that kind of specialized training.
- ▶ One objective of company financial management is to step into this knowledge gap; they have the tools and processes to guide business decisions consistently toward value creation. But they do not always apply them. Thorough, explicitly value-based analysis tends to be applied only to big-ticket outlays and not to the many other business decisions that hold implications

for value. The influence of value-based methods and tools also can be subverted by pay-related biases and weak accountabilities within the budget process, as well as the competing priorities contained in badly designed incentive plans.

In many instances, the issuance of an option is a rather poor trade from the company's perspective. Options are costly financial claims to the enterprise, but many participants may discount them due to their complexity, outsized risks, lack of participant control and long timeframe typically involved in earning large gains. Cash does not pose such difficult valuation problems, and it can be an efficient medium of exchange for pay transactions just as it is for many other transactions in the economy. Options-based barter really should not be expected to work all that well.

Stock and options can capably fulfill other important goals of compensation design, such as enabling the company to compete effectively for executive talent. In that regard, stock-based incentives simply are used to deliver value and mimic market practice. Another key driver of options usage is its favorable book treatment, although this likely encourages overuse and high dilution.

Generally, options and stock gains for management are in line with shareholder returns, although granting practices and the occasional re-pricing can seriously disrupt this linkage. In some settings (e.g., start-up high technology businesses and other high-growth settings), the business dynamics may cause options to function relatively well as incentive devices. Most larger companies, though, do not fit that profile, and their use of stock-based pay has gone far past the point of diminishing returns.

Issue No. 2 – Flawed Metrics

Bonuses and other operating incentives continue to be based almost entirely on measured financial performance. Companies should continue to be concerned

about the poor financial yardsticks most commonly used and their harmful effects on business decisions and performance. The following are common issues:

- ▶ Return on equity can be driven as strongly by financing decisions as by the operating results that most of management is charged with delivering. The same is partly true for EPS.
- ▶ Many "growth" goals such as income and revenue do not pay enough attention to capital usage, though capital usage is decisive in achieving value creation.
- ▶ Heavy emphasis on margins or return on investment capital (ROIC) can impart an anti-growth bias.
- ▶ EPS, a purportedly "simple" measure, actually reflects many complex accounting determinations.
- ▶ Most metrics do an incomplete job of portraying relative performance (e.g., against peers, among business units and over time), confounding the basic performance assessments they are supposed to enable.
- ▶ Within many incentive and target-setting structures, metrics impose a short-term bias upon business decisions.

Also, most financial measures are strictly historical and therefore do not always capture leading indicators or drivers of value. Fortunately, that is not a big issue for executive-level management. These teams have broad, long-range impact on the overall company or part of it, so their performance usually can be rewarded sensibly based on their contributions to financial results over time.

Overall, though, the main problem is that even now, years after the "metric wars," management incentive plans still are bedeviled by basic deficiencies of traditional financial metrics.

Issue No. 3 – Budget Process Working Against Incentive Design's Main Objectives

The classic criticism of the process of setting bonus goals at many companies is that management can get paid more to manage expectations than to manage the

business. Pay depends on budgets, so budgets are sand-bagged routinely. Aggressiveness is penalized from an incentive standpoint, since aggressive budgets simply raise the bar for a given pay opportunity. The process is often seen as unfair, irking many members of management. Pivotal resources (money and management time) likely are misallocated.

This is not what the incentives and planning process are supposed to accomplish. In fact, this could not be more in opposition to the idea of a high-performance culture. And this method – annual incentive targets based upon internal budgets – is used in more than 75 percent of plans.

Issue No. 4 – Incentive Plan Terms that Compound the Budget (or Target Setting) Problem

Caps, floors, weightings, circuit breakers, award leverage: these are common terms of incentive plans. They drive the connection between results and pay, but they often are set without a direct connection to factors that ought to drive them, such as:

- ▶ The risk/reward element of the incentive strategy
- ▶ The likely variation in business results around a given target
- ▶ The extent to which the schedules should vary from one business unit to another
- ▶ Incremental capital requirements attending various rates of business growth
- ▶ The interaction of the plan with other incentive arrangements.

Why is this a major issue? Many executives are operating within performance schedules that:

- ▶ Do not fit their business prospects very well
- ▶ Are structurally unfair in relation to other companies in their industry or to other business units within the same company
- ▶ Pose a strong chance of an unreasonable outcome.

When all the complex moving parts of a typical incentive plan are considered, one often sees some sur-

prising results. For example, a large manufacturer of tools and other products used three plausible drivers of economic profit in its bonus plans and believed that it had synthesized, through this design, an overall bonus structure encouraging improvement in economic profit. Instead, the target-setting methods and weightings conspired so that the plan's outcomes had no relation to economic profit, across business units or over time. In fact, the plan's weightings on sales growth, margins and capital turnover, taken together, were strongly encouraging economically unprofitable growth.

Issue No. 5 – Executives with Little Stake in Long-term Results at the Business-unit Level

Long-term incentive rewards are denominated mainly in parent company stock. This is true for corporate officers and also for those who run business units. The only element of the structure with any “line of sight” – any connection to the actions that business-unit executives actually undertake – is the bonus plan.

The bonus plan does not encourage executives to focus upon the longer term. On the contrary, business decisions that might lead to longer-run rewards (to future bonuses, basically) are spurned routinely in favor of ones offering a bonus improvement in the current year.

Business-unit managers should not be expected to act like owners when they are not paid to do so. There are major inconsistencies between the financial nature of an ownership claim (continuous, long-term, unlimited and concrete) and the financial stake inherent in a bonus plan (limited, short-term, discontinuous and tenuous). Business-unit executives are rarely paid to maximize long-run value. They are usually paid to manage results into a modest, predictable range in the near term.

Methods and Solutions

Companies can do a lot to improve the efficacy of their management incentive plans. They can get a much

better yield from the enormous investment made in such plans by using the following methods and solutions.

No. 1 – Make Better Use of Operating Incentive Plans

Instead of having incentive plans based so heavily on corporate stock, consider shifting these resources in the following ways.

► *Shift pay opportunities toward explicit goals and measurable results.* This is accomplished through cash incentives like performance plans (basically long-term bonus plans) and better-functioning annual incentive plans, and through hybrid plans that feature corporate shares being earned based on measurable goals (e.g., share or option grants with performance features). This increases the “line of sight” inherent in incentive plans, clarifying the linkages between business decisions, business results and incentive pay. Those critical links are drawn poorly by the stock-based incentives that dominate the landscape now.

► *Shift operating incentive structure toward the longer term.* Incentive structure has a bias toward the short term at many companies, with bonus pay attracting notably disproportionate attention from management. Shifting more pay opportunities into the longer term addresses this directly. Also, certain issues with traditional financial metrics become less serious within a long-term incentive plan. Lastly, shifting incentives to the long term may be useful from the viewpoint of overcoming risk aversion. As a practical matter, the way to increase the time horizon of an operating incentive structure will not be to reduce bonus opportunities, but to shift long-term incentive pay from grants of pure options and restricted stock into long-term performance plans and other vehicles. Another general tactic is to lengthen the focus of bonus plans. This can be done with target setting and measurement methods that create a more continuous and concrete financial claim against future years’ results.

► *Shift of long-term incentive opportunity toward the*

business-unit level. This can be accomplished by placing higher weighting on business-unit results within performance plans or by putting in phantom stock plans or subsidiary equity plans based on business-unit value. This shift is doable; most companies have groups, divisions and profit centers whose separate performance (overall financial results or value drivers) can be tracked reasonably well. They also have bonus plans that already disaggregate results along business-unit lines. However, there are issues related to teamwork, enterprise-wide sharing of resources and inter-unit transfers of people and goods. A strong shift of long-term incentive pay toward the business unit level is more appropriate for relatively independent business units. But the overall shift should not be controversial. Of the \$100 million in executive incentives spent by a typical company, upward of \$90 million is delivered based on corporate results.⁵ Most incentive plan participants have little influence on corporate results and even less on stock price, a fact that largely invalidates the idea of an “incentive” where the bulk of the \$100 million in incentive expense is concerned. So even a modest shift in emphasis toward the business-unit level can greatly increase “line of sight” from the current, weak level that prevails.

These three directional shifts all may carry unfavorable accounting consequences; often a matter of some concern to those involved in designing or approving incentive plans. First, executive incentive design should be driven by an emphasis on shareholder value creation, not by its portrayal in financial statements. Regarding bookkeeping as a purported advantage of option plans:

1. Company financial results enable investors to evaluate stock-based incentives and their transparent dilution effects (new disclosure rules in the United States will expose share usage even more thoroughly). A September 2001 Bear Sterns report, for example, estimates that operating income for

the S&P 500 would drop by 8 percent if the costs of stock-based pay were considered more fully.

2. Stock prices reflect this type of cost rather clearly. For example, a widely cited study appearing in the November/December 1997 issue of the *Financial Analysts Journal* found significantly greater correlation of stock prices to diluted earnings than to undiluted earnings. This suggests that the stock market, when pricing corporate shares, is well aware of stock options and their dilution.
3. Focusing upon the book advantages of options in isolation, note that non-qualified stock options and stock appreciation rights and options can be structured as economically equivalent claims from the company's viewpoint. This is true when net option gains are satisfied with shares purchased on the open market at the moment of exercise, creating similar cash costs, generally similar U.S. tax treatments and similar dilution since no new shares are issued. In this case, the distinction between cash-based pay and stock-based pay is reduced to their accounting treatments.

Empirical evidence suggests that when the stock market is faced with a choice between the accounting portrayal of events and its economic implications, it will price the shares based upon economics and pay little attention to the accounting.⁶ Where options are concerned, this general finding suggests favorable book treatment is not a means of escape from the economic implications of making options grants. Rather, options accounting is precisely the sort of sleight of hand that the stock market sees through and prices well. It is highly unlikely that a typical company's stock price is escaping the obvious dilution from stock-based incentive plans.

The stock market has made its rules clear and there is no reason that stock options should be an exception to them. The differential book "costs" of operating incentives are not real economic costs to nearly the

extent that companies believe them to be. Overall, belief in the book advantages of options – in the idea that options accounting keeps company stock prices higher than they otherwise would be – appears to be a broadly held financial illusion. This is unfortunate since the focus upon bookkeeping skews incentive design greatly and renders it ineffective for most participants.

Despite economic arguments and evidence, book costs often are a serious practical concern. In these cases, approaches like accelerated vesting options or stock grants or even subsidiary equity may be practicable. They can be used to place substantial leverage and weight on operating results (of the corporation or its business units) while limiting or cutting out profit and loss charges.

No. 2 – Improve Methods Used to Set Incentive Plan Targets and Ranges

The following two approaches should help separate pay-related performance targets and ranges from the company's budget process.

- ▶ Set targets based on measured expectations of company shareholders.
- ▶ Use various mechanical algorithms to set targets.
Shareholder value is based upon expected future performance. (See Figure 1, Page 66 for a very abbreviated version of the business valuation process.) A company's stock price reflects expectations about its future performance. These expectations can be measured using financial methods. It is worthwhile to measure shareholder expectations (See Figure 2, Page 66) when setting incentive goals since:
 - ▶ They constitute an outside source of information about performance goals, one not muddled by the company's internal budget negotiations.
 - ▶ They come from shareholders, a group of people whose views matter to senior management and the board.

As noted earlier, stock and options do not come with instructions on how to create value. But stock

FIGURE 1 Valuing a business

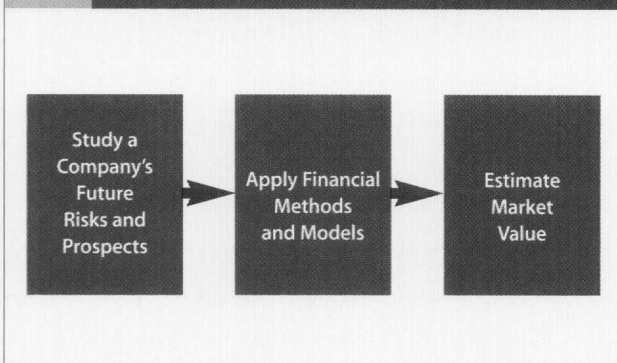
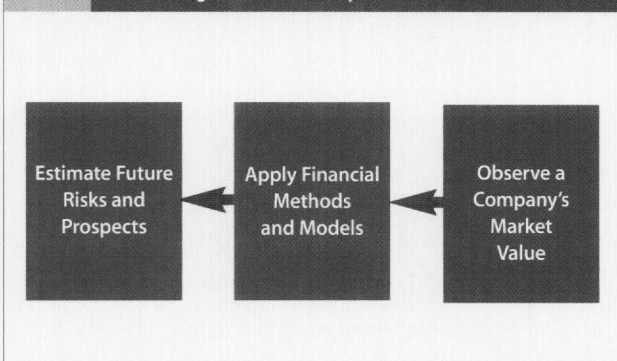


FIGURE 2 Measuring shareholder expectations



prices do reflect a lot of information useful to the task. One simply has to extract it. But how?

Basically, one fits a valuation model to a company's stock price using tested parameters from securities markets. This process exposes information about company performance – the levels of future performance that support the valuation of company shares. These overall goals are then distributed among the company's operating units, again using market-based guidance. At the end of the process, the company's goals end up much closer to external, shareholder criteria and much farther from internal negotiation.

Similar methods can be used to set ranges around targets. Under the valuation-based method just described, if the company hits the expected performance levels, then the predicted level of return provided to investors is equal to the company's cost of capital. A similar analysis can be used to determine thresholds and maximum performance levels. The

maximum performance level can be set at a performance level corresponding to two times the cost of capital, for example, and the threshold can be set at a zero level of return. Ranges also can be set by studying the variability of financial results around past targets or trends, again bypassing a process of negotiation.

Results can be used to replace budget-based targets or as one source of input into the existing goal-setting process.

A second general approach to consider when setting targets and ranges is to use financial algorithms rather than negotiated budgets. For example, a \$3 billion manufacturing company sets incentive targets each year equal to total business return (TBR) of 15 percent from each business unit. (The 15 percent TBR level works out to be about equal to shareholder expectations for the overall company.) The particular variant of the metric TBR, in this case, is equal to the sum of:

- ▶ Capitalized change in after-tax operating profit, which represents the overall increase in the value of the business made evident by this year's operating results
- ▶ Free cash flows, equal to the amount of after-tax operating profit left for distribution to owners after satisfying the cash reinvestment requirements of the business (that is, after subtracting the overall change in the amount of invested capital.)

This target-setting process sets levels of after-tax operating profit and capital needed from each business unit. It also determines levels corresponding to threshold performance (0 percent TBR) and maximum performance (30 percent TBR). Results are then converted into the metrics actually used in the incentive plans (operating income growth, ROIC, EPS, etc.). At the end of the process, participants have bonus targets that:

- ▶ Have nothing to do with budgets, so there is no point in sandbagging goals
- ▶ Are set uniformly, so there is no reason to worry that other business units may have gotten a better deal through negotiation

- ▶ Are set consistently from one year to the next, so participants have a continuing stake in business results and are encouraged to make decisions with an eye toward the longer term
- ▶ Are fair, since they are tailored to accommodate important differences among business units (since many different profiles of income growth and cash yield can be used to meet a "total return" standard)
- ▶ Roll up to a reasonable corporate standard and down to reasonably apportioned targets
- ▶ Connect tightly with value creation over time.

No. 3 – Emphasize Shareholder Value

One should make more prominent use of value-based methods within the design of incentive plans. These methods are used to create incentive plans that focus on the basic drivers of shareholder value reflected in most business valuation models:

- ▶ Long-run operating results
- ▶ The use of capital by the enterprise
- ▶ Risk and the cost of capital.

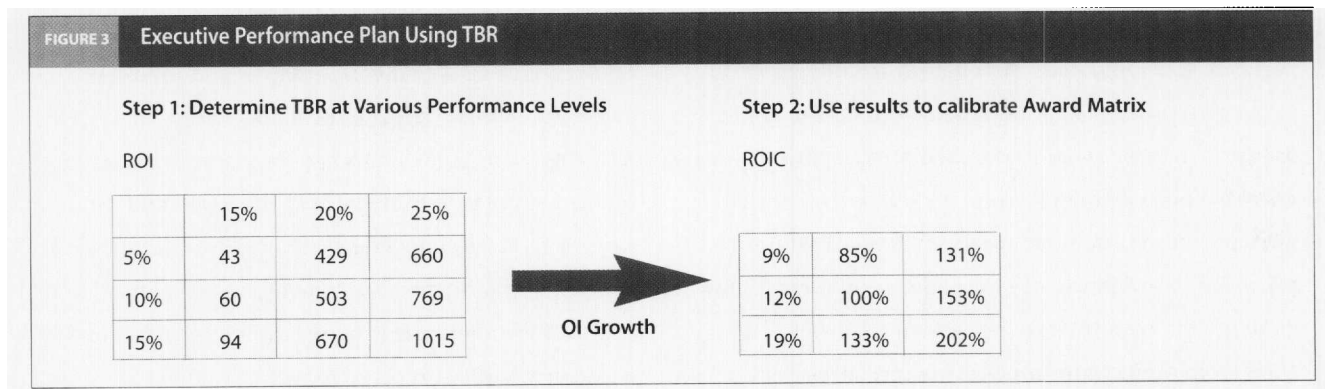
Depending on a company's circumstance, many useful methods can be applied. Two examples follow:

In the first case, Towers Perrin designed a long-term performance plan based upon the familiar metrics operating income (OI) and return on invested capital (ROIC). The goals were arranged in a matrix format with wide performance ranges. And the award payouts were scaled to the levels of TBR implied by each performance level. (See Figure 3.)

This general approach allows a company to implement a shareholder-value-based incentive plan while continuing to use traditional metrics. The method is applicable to both annual and long-term incentive plans.

Another company wished to put phantom stock plans into each of several business units. This time, the implemented plans were based directly upon the metric TBR. Each year, participants receive option-like grants of phantom stock that pay out over time based on the level of TBR earned by their business unit. A \$100,000 phantom stock grant, for example, would pay out \$50,000 if TBR worked out to be 50 percent of beginning value over the grant term. This arrangement was:

- ▶ Competitive. The grants resemble option grants and can be benchmarked directly against them.
 - ▶ Fair. The plan allows each business unit to earn gains by increasing income, generating cash flow or both. As noted earlier, this simple "total return" format is very useful in scoring the results of diverse businesses in a roughly consistent way (it addresses quite a number of the basic issues that typically confound performance comparisons).
 - ▶ Fiscally prudent. Awards are earned based on (and funded by) actual income and free cash flow levels.
- Other plan safeguards include overlapping grant cycles, staggered vesting, subtraction of incentive accruals from operating income and controls on plan granting and dilution.



► Simple. Plan communications is as follows: “Your business is worth 10 times its operating profit after tax. So, if you make income rise by one dollar per share, the share price (and your gain) rises by \$10. Also, you get credit for generating cash flows.”

► Value-driven. The trade-off between getting gains from free cash flow (which is net of all increases in capital) and value gains (which are driven by income) has the effect of attaching a reasonable, consistent cost to capital.

In the past, conversations about incentive metrics were about whether or not to do a particular value-based metric like economic value added. Almost all companies answered that question with a “no,” for a range of reasons including complexity of the metric and basic difficulties with setting up incentive plans and communicating them. But companies do not really have to choose between traditional metrics and value-based ones. Many approaches to plan design and goal setting can emphasize the key drivers of value – operating results, capital and the cost of capital – in proportions that are in sync with shareholder value criteria. This can be done without adopting an explicitly value-based metric.

Value-based methods can be used to overcome the bulk of the troubles with the metrics used in incentive plans for executives. And the barriers to using these techniques are not high. A barrier sometimes cited is the complexity of value-based incentives. Actually, traditional incentives can be at least as complex.

Traditional incentive systems have a lot of moving parts that often conspire to conceal many issues with plan design and calibration. Figure 4, page 69, depicts the basic influences on incentive pay for a typical incentive plan participant.

As Figure 4 illustrates, many factors affect incentive pay within even the most typical structure. From a participant’s viewpoint, that can make it hard to know whether a particular business decision will pay off or

not. And from a company’s viewpoint, it makes it difficult to be sure you know what you’re paying for.

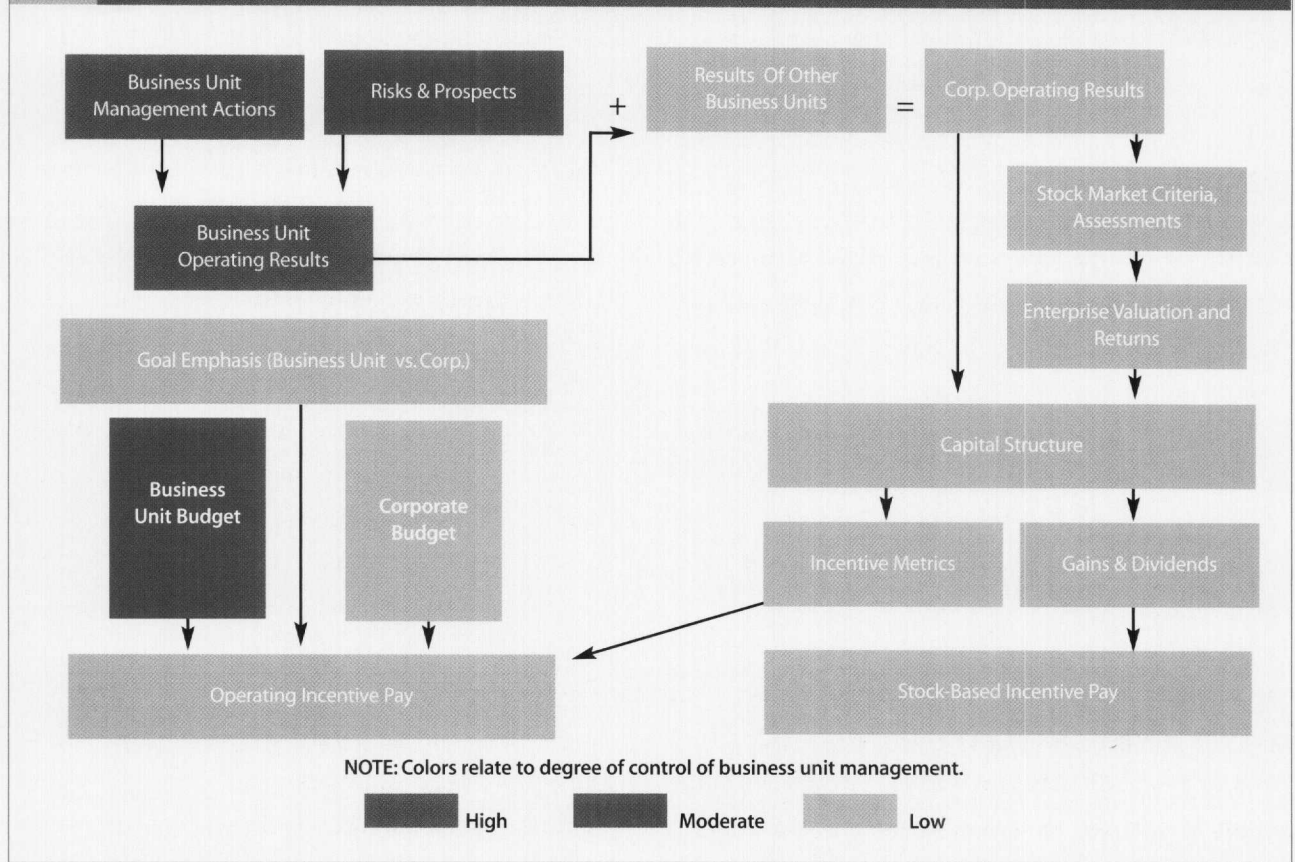
No. 4 – Test the Incentive Structure

Testing and simulation techniques provide a way in which all of the design choices in incentive structure – pay mix, choice of long-term investment instruments, leverage, metrics, weightings, ranges, circuit breakers, overall calibration – combine to pay off for particular business results. Unfortunately, these important terms in companies’ plans often consist of an accumulation of various one-off design choices made in response to issues pressing on the company’s incentive plans at the time. The combined results of these design decisions can be rife with unintended consequences and ripe for redesign.

Comprehensive testing should focus on the structure’s overall efficacy and isolate the impact of changing its aspect(s). For example:

- In the simulation cited earlier, incentive pay was driven only 20 percent by performance of the management team (evidenced by measured value creation at the business-unit level).
- This figure can be increased to 100 percent by creating annual and long-term incentive plans that focus on value creation of the business managed by the team. This approach would eliminate the influence of other business parts or stock market fluctuations from its pay structure. Team members would still bear some uncertainty related to conditions and prospects in their own business, but these are entrepreneurial risks that most executives consider acceptable, and inescapable as a practical matter. These are not “bad risks.”
- Most companies desire a strong emphasis on corporate results as well as those of the business unit, for a range of good reasons. So a 100 percent-business-unit structure could be dead on arrival as a proposed approach. In this case, the company may wish to test designs that follow a more corporate path. In one

FIGURE 4 Influences on Incentive Plan Outcomes



example, using a bonus-based 25 percent upon corporate results and long-term incentives denominated in corporate stock and earned based upon business-unit results, the particulars of plan design can bring the measured level of line of sight up to 75 percent.

High Expectations, Big-Ticket Concerns

Executive incentives are important to business performance. The executives at issue in this discussion control trillions of dollars in corporate capital. They face very high expectations for future performance, evidenced by the still-high market valuations of their equity. They also face a stock market that is likely to be less generous in the future, and more discerning, in terms of the returns that it accords.

These conditions are driven, in turn, by a competitive business environment where opportunities are great but change is quicker, decisions of all kinds are

more complex, and small performance advantages are decisive. How to induce key executives to make decisions consistently in the long-term interests of shareholders is a big-ticket concern for any company. ^[W]

Webnotes

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- ⇒ Type in this key word string on the search line: "partnering or alliance" OR "joint venture" OR "networking or collaboration"

Author

Richard Ericson specializes in management and rewards systems emphasizing principles of shareholder value creation. He is a principal in Towers Perrin and is one of the firm's leaders in the area of value-based incentive design. He is located in the firm's Minneapolis office and works with many large public and private companies internationally.

Ericson was a business valuation consultant for seven years before entering the executive compensation consulting field in 1990. He was a manager in the business valuation practice of PriceWaterhouse. He is a frequent speaker to professional and industry audiences on the subject of value-based systems for target setting, performance measure-

ment and executive rewards. He is responsible for Towers Perrin's training efforts regarding the use of financial methods in executive incentive design and has developed a suite of methods and tools used in client projects globally.

Ericson holds a Bachelor of Science degree in finance and a Bachelor of Arts degree in French literature, each granted summa cum laude from Northern Illinois University. He holds a master's in finance and accounting from the University of Chicago.

Endnotes

¹The economic cost of stock-based incentives (expected value at the time of grant) is about \$75 million per year for a company with revenues between \$5 billion and \$10 billion per year and with performance in a typical range (after-tax margins of 5 percent to 10 percent of revenue, net income of \$500 million), market capitalization (P/E ratio of 15X, market cap of \$7.5 billion), share usage for stock-based incentives (2 percent per year for a total grant size of \$150 million), granting mix (75 percent options, 25 percent full-value grants of restricted stock and performance shares), and grant valuations (40 percent of face value for options, 80 percent of face value on average for full-value instruments). Option grants total 75 percent of the \$150 million in stock-based incentive grants, or \$112.5 million. At 40 percent of face value, these are worth \$45 million. Grants of restricted stock and performance shares comprise the other \$37.5 million in stock-based incentive grants. At 80 percent of face value, these are valued at \$30 million. Cash-based incentives - bonuses and cash performance plan payouts - cost another \$25 million based on typical levels of expense in relation to after-tax income (5 percent). The total annualized value of incentive opportunities is \$100 million.

²To generate the simulation, market-based parameters were assigned to incentive plan terms and to financial performance. Typical variation was applied to operating income in the near term (15 percent root mean square error around 10-year regression trend line) and this variation drove the 10,000 scenarios examined. Default assumptions about capital usage and capital structure were used to convert each scenario's operating income into the measures used in the annual incentive plan (constant capital structure in market value terms, excess equity cash flows used for share repurchases at ending share price each year). The most common measures were used at the corporate and business unit levels (EPS and operating income). Using this information about financial performance, annual incentive plan payouts were simulated. The annual incentive plan was assumed to comprise modal award ranges and leverage (80 percent -120 percent performance range, 50 percent - 200 percent payout range). A random error of one percentage point from most likely forecast for growth in operating income was used to determine the target used in the annual incentive (this was done in order to simulate uncertainty, but not bias, in the annual incentive target setting process).

Stock returns (and option gains) were simulated using a 10-year discounted cash flow (DCF) model with separate assumptions applied to near-term, medium-term and longer-term performance. Year one financial results in each scenario were the same ones used in simulating the bonus plan. Medium-term results were based upon adaptive revision of the DCF forecast based upon variation in one-year results. Modest random movement was attached to long-run expectations for business growth and also to the cost of capital (levels of variation resembled the variation in long corporate bond yields). The model's outputs were also validated by market norms; overall, the DCF simulation generated a pattern of stock returns resembling the stock market (continuously compounded shareholder return with a mean around ten percent, a standard deviation of about thirty percent and variance driven about one-half by consolidated financial performance over a five-year period. The 50 percent explanatory power attributed to financial performance was higher than typical. This was done in order to give some weight to the stock market's anticipatory nature and to its ability to reward for business decisions based upon expected rather than actual results).

The simulation of the incentive structure focused in this case upon a typical participant: a member of top management of a business unit. Movement in business unit financial results was assumed to be largely within the control of business unit management, or at least to represent a tolerable or customary risk. Variation in results of other businesses was assumed to be outside of the control of business unit management, as were market valuation parameters like the cost of capital and very long-run growth expectations. In this example, the overall "line of sight" figure of 20 percent is

the amount of variation in incentive pay that is explained by variation in business unit results. The other 80 percent of the variation in incentive rewards was driven by variation in the cost of capital, in long-run growth expectations, in performance of other business units or in the outcome of the annual budget process.

³*Harvard Business Review*, November 2001: "Corporate Budgeting Is Broken. Let's Fix It," by Jensen, Michael C. Pages 95-101.

⁴This result stems from Towers Perrin's research of 20 years of data for the S&P 500 and also from research we've reviewed over many years. As one example of typical findings, a report from The Research Foundation of the Institute of Chartered Financial Analysts published in 1996 ("Company Performance and Measures of Value Added") finds very low correlation between a range of metrics and value creation. Towers Perrin findings are that a wide range of metrics exhibits explanatory power (r-squared) of 50 percent or less (normally far less) over one- three- and five-year periods. The 50 percent figure used to calibrate the DCF model used in the simulation was generous in this regard.

Higher explanatory power is sometimes attributed to certain value-based measures. Statistical tests in these cases often involve correlating the metric (divided by the "capital" construct used in the metric) to market value (also divided by capital). In those instances, results appear to be biased upward by the presence of capital in both the independent and dependent variable, particularly in cases in which capital figures are heavily adjusted (often the case with value-based metrics) or when the sample includes extreme observations. As an illustration of the potential for distortion caused by this "denominator effect," consider an example in which market value is a fixed multiple of annual results (e.g. operating income) while capital is a random number. In this case, operating income determines value and capital (and ROIC, by extension) provides no information about value. The correlation between ROIC and market value to capital would be 100 percent nonetheless due to the presence of capital in the denominator of each metric. In this extreme example, an utterly meaningless metric can be shown to have high correlation with market value.

⁵Almost all of the \$75 million in stock-based incentives is driven by overall corporate stock price performance, since it consists overwhelmingly of stock options and restricted stock grants. Performance share plans are denominated in shares and also are based heavily upon consolidated financial results (or total shareholder return; another stock-based element). Over half of the \$25 million in cash incentives typically is based upon overall corporate results. Executives at both corporate and business unit levels typically have substantial pay at risk within the bonus plan based upon corporate results (based upon goal weightings and upon corporate "circuit breakers"). Performance plans are heavily corporate in terms of both participation and measurement.

⁶Seminal studies of LIFO conversions made this point starkly clear many years ago as has much empirical research since. Regarding LIFO conversions, see the Sunder article in the 1973 *Empirical Research in Accounting* and Biddle and Lindahl in the *Journal of Accounting Research*, Autumn 1982. The more general point about the stock market's preference for the economic portrayal of events (cash flow) over their accounting characterization is one upheld broadly for decades and a finding made clear in any review of relevant financial research. Examples include Hong, Mandelker and Kaplan on purchases versus poolings in *Accounting Review* in 1978, an SEC study on R & D announcements published by the Office of the Chief Economist in 1985, and Copeland and Lee on exchange offers, stock swaps and their EPS effects published in *Financial Management* in 1991, and Kaplan and Ruback on the importance of cash flow in driving business value, "The Valuation of Cash Flow Forecasts: An empirical analysis," NBER working paper 4274).

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