

How Proper Incentives and Governance Create Long-Term Value

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Executive compensation plans have come under fire as one of the causes leading to the economic crisis. However, devising appropriate compensation plans is no easy task, whether at large, publicly traded companies or small, private ones, even for seasoned professionals.

Motivation

Executive compensation policies should motivate high-level managers to make decisions that are compatible with the organization's strategy. However, many would argue such compensation practices failed to achieve this mission over the past two years, or adequately discourage executives from excessive risk taking. Already a complex issue before the recent economic crisis, executive compensation is now a critical issue for organizations of all sizes.



[1]

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In general, while public companies appear to have stolen the executive compensation spotlight, compensation plans for private companies remain an essential motivating factor for employees. These plans can provide smaller companies with the power to attract talented individuals as well as a mechanism to motivate key employees.

There are four fundamental steps directors, executives and others involved in the compensation-setting process can employ in attempting to satisfy stakeholders while also ensuring executives and employees remain properly incentivized.

Executive Compensation Defined

For the purposes of this article, compensation is divided into four elements: base salary, benefits (including perquisites), short-term variable pay and long-term incentives. While the first two categories are self-explanatory, short-term variable pay is compensation not included in base salary that relates to performance achievements over a short period of time (generally

a year or less) and most often does not exceed a typical business cycle. Short-term variable pay typically includes bonuses and incentive payments earned when an executive exceeds pre-defined goals. Long-term incentives are compensation components that reward executives for achieving goals over a time period that exceeds one business cycle. The equation below presents a definition of executive compensation using four compensation elements.

$$\text{Total Executive Compensation} = \text{Base Salary} + \text{Benefits} + \text{Short-term variable pay} + \text{Long-term incentives}$$

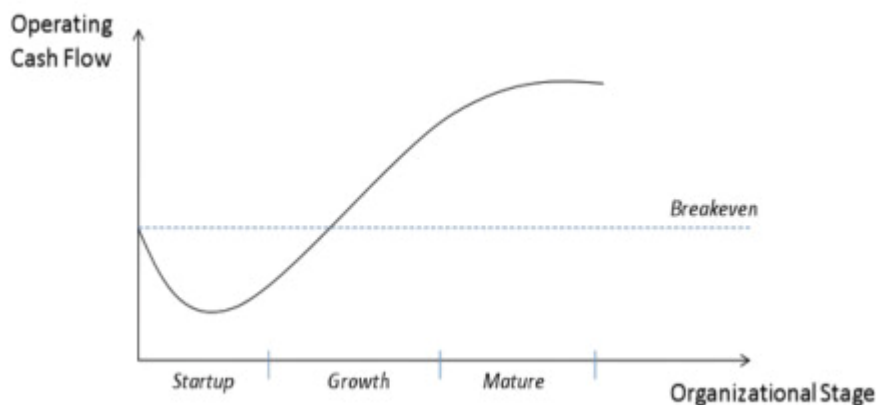
All other things equal, talented executives will be looking for compensation packages whose *expected value* is commensurate with their historical experience and expertise, as well as the potential value they can bring to a firm. A compensation package's expected value is:

$$\text{Expected Value} = \sum \text{Compensation Element}_i \times \text{Likelihood of Payout}_i$$

Within this equation, each of the four previously mentioned components of executive compensation is multiplied by its likelihood of payout to arrive at a compensation package's expected value. Note that the likelihood of payout will generally vary by component. The structure of executive compensation packages, as well as the likelihood of payout, largely depends on the nature of a compensating organization and its strategy.

Step One: Understand the Nature of the Organization and Its Strategy

The first step in devising an appropriate compensation plan requires compensation managers to understand their organization's current stage of development and strategy for its future. For the purposes of this article, we separate organizations into three categories: start-up, growth and mature organizations. Start-up firms, by definition, are those that are just beginning life. In their nascent stages, these organizations generally do not possess positive cash flows from operations, though they may have some form of revenue stream or established customer base. Growth firms are organizations that are more mature than start-ups, but are continuing down a path of significant year-over-year cash flow growth. These firms generally have positive cash flows, but they may lack historical stability. Some growth companies serve developing markets that may not yet allow the company to experience stable revenues. Mature companies do not see consistent year-over-year increases in cash flows above the rate of GDP growth. They frequently participate in nongrowth industries and generally achieve modest cash flow growth through cost containment rather than revenue expansion. Exhibit 1 depicts these organizational stages with respect to a firm's operating cash flow.



[2]

Exhibit 1: Stages of Development

For several reasons, compensation managers must understand the nature of the organization, its strategy and the metrics it values. A company's ability to compensate its key employees—and the ways by which it can do so—is greatly dependent on the stage of the company. Executive compensation plans must also reinforce the organization's strategy in order to ensure long-term value is created for shareholders.

Many start-ups have strategies that are evolving with the milestones that they meet. Their products may not yet be fully developed. However, virtually all start-ups are united in one element of their strategy: they want to become cash flow positive. Positive cash flow allows a start-up to become a viable venture capital candidate. It also signifies the firm has taken a step toward the growth stage. In order to assist a start-up in building cash flow, executives are frequently compensated through long-term incentives. Such a compensation scheme allows the company to preserve cash while ensuring executives are incentivized to build long-term value in the company. Executives cannot realize the full value of their compensation package until a financing or liquidity event takes place. Even with such an event, the full payout of a long-term incentive package might not be realized. Because long-term incentives have less likelihood of payout as compared to annual base salaries, an executive may require greater amounts of such compensation in order to compensate them for the chance that their incentives might not realize their initially estimated future value.

Within the growth stage, base salary and benefits become increasingly standard components of executive compensation. If a company has made it through its start-up phase, its risk has decreased commensurately with its success. Consequently, founders and investors will likely be less willing to provide executives with portions of stock or options befitting a start-up, though these may still be important components of an executive's pay. Furthermore, the company's cash flows permit higher base salaries to be paid to these individuals, and short-term incentives, including annual bonuses, become increasingly important in this stage.

By the time a company reaches the growth stage, a foundational strategy is in place. Compensation managers should examine this strategy when tailoring executive compensation packages. For instance, a company might possess a strategy to produce the highest-quality goods on the market. In such a case, an executive compensation package should contain metrics related to customer satisfaction, customer retention, returned items and warranty claims.

Once the organization reaches a mature stage, it will be difficult to motivate employees through long-term incentives, though short-term bonuses are frequently used to compensate key individuals. Unless a mature company is growing revenue in some area of its business, it is unlikely that its value will increase through revenue growth. Rather, its value is likely to appreciate through cash flow and earnings stability. This stability is often a component of mature organizations' strategy which is sometimes achieved through diversification or divestiture of nonperforming assets.

Exhibit 2: Plan Components by Stage

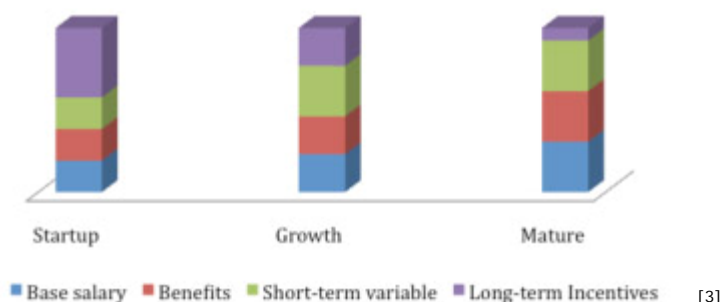


Exhibit 2: Importance of Plan Components by Organizational Stage

Step Two: Select Appropriate Compensation Metrics

Compensation managers should use a variety of metrics in evaluating the performance of executives, including financial, product quality, operational and internal growth goals.

Financial. In order to more accurately assess an executive's performance, compensation managers should focus on organizational metrics that most closely resemble the company's operating characteristics. Two such metrics related to the organization's finances are operating cash flow and EBITDA (Earnings Before Interest, Taxes, Depreciation and Amortization). Compensation managers should use these metrics to manage compensation plans for the same reason they are used or examined by valuation professionals: they perhaps best showcase the operating nature of the business.

Although not an accrual-based metric, operating cash flow, rather than net income, can generally give compensation managers a clearer picture of the company's affairs. Moreover, operating cash flow takes into account a company's working capital (receivables, payables, and inventory) while eliminating noncash charges associated with depreciation. EBITDA is similar to operating cash flow; however, it does not take into account working capital or the firm's capital structure. Capital structure may be an important consideration for many companies as they deleverage their balance sheet and control interest expense in the near future.

Financial metrics are generally used in defining parameters for short-term variable pay or long-term incentives for companies of all stages. For instance, an executive might receive a bonus for achieving market share or earnings growth. Nonfinancial metrics, however, should be incorporated into these components of executive compensation.

Nonfinancial. Other metrics should also be used in devising executive compensation plans. In the early 1990s, Balanced Scorecard pioneers Robert S. Kaplan and David P. Norton asserted that financial metrics should, at most, represent one category of metrics that managers should employ in measuring their firm's performance. However, while the approach advocated by Kaplan and Norton is now used within the strategy department of many organizations, it appears the philosophy it espouses has not yet been embraced in most compensation plans.

According to Charles Elson, director of the John L. Weinberg Center for Corporate Governance at the University of Delaware, executive compensation is typically based on "a blend of earnings targets, sales targets, sometimes the success or failure of dispositions or acquisitions and the company's stock price." According to Elson's description, a Balanced Scorecard-like approach to executive compensation seems conspicuously absent. It is simply a reflection of the environment in which many companies operate: whenever a business is valued,

nonfinancial metrics rarely play a part in the valuation. However, these metrics are some of the most important to track, especially in organizations that are focused on achieving high growth levels. As Benjamin Heineman, former general counsel of General Electric and fellow at Harvard's JFK School of Government, recently stated, "Executive compensation shouldn't merely compensate individuals for short-term stock price appreciation."

A balanced approach comprised of numerous metrics should be used in evaluating key executives and managers. The saying, "What gets measured, gets done," appropriately speaks to the incentives created by executive compensation. Compensation plans will always focus in part on financial metrics. However, the best CPA compensation managers will recognize that financial metrics are outputs of organizational processes; they are not inputs.

The method by which the organization operates will drive top-line growth and bottom-line improvements. Product quality and operations often tie directly to financial results. In general, compensation managers should look to include metrics related to product quality, operations and internal growth—examples of which are shown in Exhibit 3—within their executive compensation plans. Inclusion of these metrics can incentivize executives to achieve organic growth through long-term value *creation* rather than short-term value *inflation* that might result through an intense focus on financial metrics alone.

Exhibit 3: Example Nonfinancial Metrics

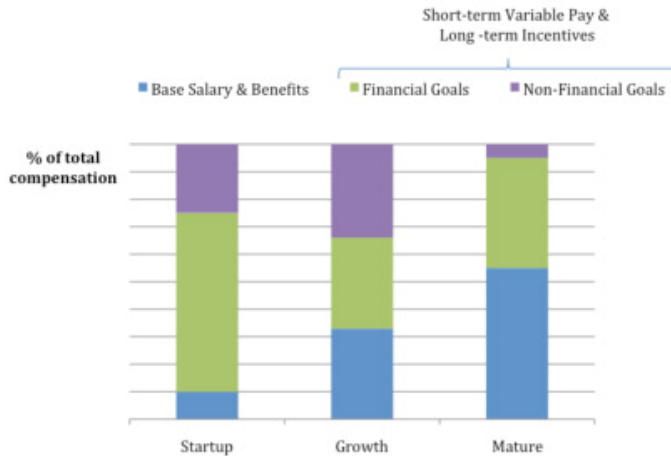
Product Quality	Operations	Internal Growth
<ul style="list-style-type: none"> • Brand loyalty • Customer satisfaction survey results • Post-sale recalls • Warranty work • Market share 	<ul style="list-style-type: none"> • Milestone achievements • R&D innovations • Throughput • Lead time • Safety record 	<ul style="list-style-type: none"> • Employee training hours • Employee suggestions received • Employee suggestions implemented

Inclusion of these metrics in compensation plans can further assist the organization in achieving its financial goals and also help executives cascade compensation metrics down through the organization.

Achieving a Balance of Financial and Nonfinancial Metrics

An appropriate balance between financial and nonfinancial metrics must be achieved for executives to be properly incentivized. The weighting between financial and nonfinancial metrics is dependent on the organization's stage. Exhibit 4 presents a sample weighting of financial and nonfinancial metrics as well as base salary and benefits. As shown in the exhibit, base salary and benefits grows as the organization matures. This growth in base salary is commensurate with the organization's cash flow-generating ability. Financial goals are extremely important for start-up companies as they travel down the road to profitability. They are also important for mature organizations looking to gain shareholder value through cash flow and earnings stability. Lastly, nonfinancial goals are perhaps most important in growth companies where profitability has been demonstrated, but sound strategy execution is needed to take the organization to the next level.

Exhibit 4: Metrics and Weightings



[4]

Exhibit 4

Step Three: Cascade Compensation Metrics Throughout the Organization

Compensation metrics should reflect the organization's nature and its overarching goals; therefore, it is imperative that such metrics be appropriately cascaded down through the organization. In smaller companies, this generally means ensuring lower-level managers' remuneration schemes mimic those of their executives.

In some cases, it will be necessary to translate high-level organizational metrics for employees to afford them ownership of metrics within their compensation packages. For instance, if directors of a company are concerned with growth in net earnings (as is typically the case), what does this mean to plant managers? Should they be measured on the firm's growth in net earnings? Would they take ownership of such a metric?

In such a situation, it is best to translate this goal for such an individual so that he or she can directly affect it: the plant manager could instead be measured on the facility's throughput, labor cost, lead time or product quality, each of which impact net earnings and are under his or her direct control. As such, this process can be more easily facilitated if high-level executives are measured on a variety of metrics outside of those directly related to the firm's finances. Such a practice allows for a more intuitive cascade of compensation metrics throughout the organization.

Large corporations pose numerous challenges to the aforementioned cascading process. A key element of executive compensation plans for mature companies is the compensation plan of divisional managers. Large corporations are often composed of many divisions, with the degree of autonomy exercised by each division varying by company and industry. Compensation of divisional managers is especially difficult because a division's financial performance may be distorted by inter-company transactions and accounting methods.

In compensating these individuals, compensation managers should bear in mind that the organization's goal for the division may differ from that related to the company itself: while the company may be in one phase of organizational development, the division may not resemble the corporation as a whole. In this sense, compensation managers should view the division as its own entity in devising appropriate compensation schemes. They must understand the division's stage of organizational development and how it differs from that of

the complete organization. Divisional managers, where possible, should be more heavily compensated on metrics they can influence, rather than those beyond their control.

Step Four: Monitor Performance of Plans

In monitoring the performance of executive compensation plans, compensation managers need to first make an objective assessment of each executive's performance. This assessment should include an investigation of the company's past performance against other firms in the industry, as well as potential future benefits that the executive has been responsible for creating. This latter component is especially important for executives operating in turnaround settings where the company might have been performing poorly prior to the executive's arrival. Much as one cannot expect a first-year football coach to lead last year's 0-16 team to an undefeated season, compensation managers should evaluate executives based on realistic expectations that may differ from company to company in a given industry.

The selection of an appropriate peer group against which executive pay is benchmarked is an important component of the executive compensation process. However, in the extreme, deference to peers can eventually lead to "herd behavior" within the executive compensation process: directors may act according to the actions of others, rather than in the best interest of the company they represent. Thus, directors should ensure that their compensation monitoring process examines not only peer actions, but also takes into account any idiosyncrasies that separate their company from its peer group.

Compensation managers must also take into account the accuracy of underlying data used in compensating executives. Most large corporations use accrual-based accounting methods which necessarily require calculation and recording of reserves, estimates, and accruals. This process inherently allows executives and financial managers to exercise subjective judgment in preparing financial statements. The larger the company, the more judgments it must make with respect to accruals. In contrast, smaller companies, especially start-ups, will use accounting methods more closely tied to cash flow—some may even use cash flow-based accounting methods. The "noisier" the data employed by compensation managers in their monitoring of executive pay, the more work they will have to perform in order to discern whether an executive's actions are commensurate with the company's strategy.

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