# Myth vs. Reality: The Key Challenges in Developing Effective Performance-Based Incentives

By Patrick Finegan, Mark Gressle and Richard McGinley[‡]

The current rage in management circles is linking cash compensation objectively to share value creation. For good reason. "Excessive" pay has become a magnet for shareholder and governmental activism, catalyzing reform at such previously impregnable fortresses as Kodak, IBM and Westinghouse. In addition, mega-mergers have returned with a vengeance—reminding investors that they need not endure under-achievement for long. Finally, the vast majority of corporate managers and directors have simply joined forces in demanding objectivity, fairness *and opportunity* from their pay-for-performance packages.

Recent cover stories in *Fortune* and *Business Week* create the impression that promoting shareholder wealth boils down to selecting the right performance measure. Subscribe to balance sheet-sensitive measures like residual income, cash flow ROI, or, more recently, EVA, and you will—by changing measures alone—maximize prospects for your stockholders. Only if you are lucky. The problem is that value-planning experts have so muddled the public forums with their peculiar formulations of performance measurement that they have diverted attention from the more pressing practical considerations of implementation.

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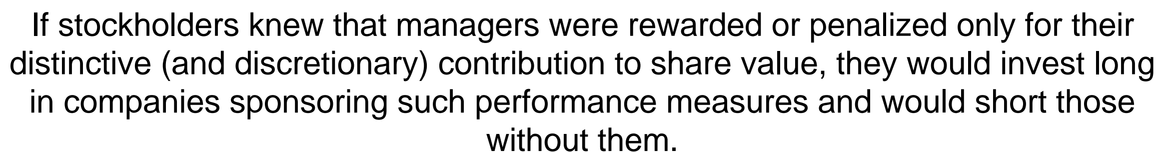

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### *Angels Dancing on a Pin*

If only the distinctions between performance measures were meaningful. We had the opportunity as partners at Stern Stewart & Co.[1] to help formulate a theoretically "pure" version of residual income called "EVA." Briefly, EVA adapted the age-old accounting definition of residual income (net income minus the opportunity cost of equity) to:

(1) include cash-basis, rather than accrual-basis, accounting;
(2) record all financing sources on the balance sheet, including operating leases;
(3) recognize the long-lived nature of research and marketing expenditures; and
(4) capture the unrecognized goodwill gained or lost from pooling-of-interest transactions and write-downs.

We contributed to a widely-respected ranking of corporate America entitled the *Stern Stewart Performance 1,000*—which showed a strong statistical correlation between a company's EVA and "MVA," or market value premium to economic book value. This correlation was, in turn, superior to MVA's correlation with ROI or earnings-per-share. Partly as a testament to that evidence, the measure found its way found its way onto the cover of *Fortune Magazine*, and into the annual reports of Coca-Cola, AT&T and GE.

The only hitch was that our internal research showed an *even better* correlation for residual income defined the old-fashioned way—before adjusting for cash basis accounting![2]

Were the adjustments conceptually inappropriate? Probably not. Converting a company's books to a new system of bookkeeping is tricky, especially when restricted to published 10-K's. Quite plausibly, better relationships would have emerged with better access to information.

Still, our rationalization begged the question, "Were the adjustments worth the effort?" More than ever, it seems residual income is being dressed up with ostensibly proprietary, value-adding adjustments. Yet such adjustments are rarely proprietary and rarely value-adding. They are, however, confusing, and thus divert valuable management attention to re-education and parallel bookkeeping systems.

### *The emperor has no clothes.*

Stripped to its essentials, the debate over performance measures is a dead one. All recognized authorities agree that capital has an opportunity cost, and that this cost must be subtracted from income in assessing profitability. For the vast majority of companies, it is adequate to net the opportunity cost of equity from net income.

### What ***are*** the issues?

#### 1. Calibration

Ask any corporate insider what the most arbitrary (and unsettling) aspect of their pay-for-performance plan is and he or she will tell you, "How much pay for how much performance?" Not, "What kind of performance?" Not even, "What kind of pay?" These are subsidiary to the fact that no compensation expert has yet justified in proxy materials or other public materials how much of a company's value creation belongs to management. Or quantified how the percentage should differ from one division's plan to another's. Or shown why bonus payouts should increase linearly with achievement, when everyone knows that the second $1 million is harder to attain than the first. To date, there has been scant attention devoted to calibration—yet calibration is the check that prevents pay-for-performance plans from be-

[1] Messrs. Finegan and Gressle. Mr. McGinley was a vice president.

[2] The precise test was whether cash-basis accounting for deferred taxes (the largest accrual item for most companies) improved EVA's ability to explain MVA. The results of the test suggested the contrary—that accrual accounting for deferred taxes improved robustness over cash-basis accounting.

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coming either (1) horribly unfair between divisions or (2) a picnic for managers.

### 2. Differentiation

Delve beyond calibration and managers will express another concern: the incentive plan compensates the economy's performance, not management's. Far from addressing the issue, many compensation experts revel in it, saying managers should bear the full brunt of economic vicissitudes, irrespective of management's contribution. We call this the "all in one boat" theory.

It's the wrong boat. If stockholders knew that managers were rewarded or penalized only for their distinctive (and discretionary) contribution to share value, they would invest long in companies sponsoring such performance measures and would short those without them. In so doing, they would hedge themselves against all economic forces except management uncertainty. Now that would be a true alignment of stockholders' and managers' interests. And it should be a central implementation topic in any pay-for-performance debate—rather than continued debate over the measure.

### 3. Integration

Last, the compensation industry has yet to associate highly aggregated measures like residual income and EVA with specific tasks of managers. Consequently, there is no way to distinguish performance between management teams or functions beyond a highly aggregated group level, and no specific hands-on advice on how to improve individual bonuses.

The truth is, not all EVA is created equal. There are many ways for a company to generate the same long-term EVA, ROI and cash flow targets. Yet only one such path promises the greatest likelihood of turbo-charging a company's stock price. Some bonus-maximizing trajectories will actually damage stock price. The point is that distilling balance sheet measures into one specific formulation of performance will never, by itself, ensure coordinated management initiative to improve share value.

### *Seeing Past the Cycles*

Obviously, there *are* success stories. Coca-Cola and AT&T are justifiably proud of their accomplishments under a straight-forward EVA-based system of performance measurement. Unfortunately, most such companies already subscribed to some form of objective balance sheet performance measures before adopting EVA. Consequently, much of the hoopla was about rearranging deck chairs. In addition, many adopters were in industries marked by strong profits, well-established pecking orders, and well-defined product lines.

What remains are the many companies facing intense competition from new sources, long and severe business cycles, uncertain industry prospects, extremely long investment cycles, and tremendous capacity by competitors to endure pain. Such characteristics describe companies in industries as diverse as health care, air travel, forest products, oil and gas, aerospace, retail, and even insurance. It is here that differentiation, calibration and integration with day-to-day activities becomes paramount.

The usual response to cyclicality is a deferral scheme—employing a series of overlapping long-term plans or a bonus bank. The hope is that if you wait long enough, the plan will smooth out economic cycles, and thus differentiate management's contribution to share value. Yet no manager would have waited out a 10 to 15-year deferral to cover the shake-out and reconstruction of the domestic and international airline industry. Some improvement might have come from indexing aggregate measures like EVA against competitors', but the index would have been fraught with inconsistencies over route exposure, unionization and product mix. Moreover, indexing would have been impossible at the cargo handling or information serv-

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ices level, because public surrogates are so few.

Nor would there have been guidance in running "what if" scenarios on identifiable sources of exposure. The typical "what if" experiment modifies one item (sales or working capital days-on-hand), and observes how it percolates through a sieve of well-defined relationships (COGS margin, corporate tax rate, *etc.*). "What ifs" are thus useful where the economy and competitors play by well-defined scripts or rules. For most industries, the players are more creative, and the environment more chaotic. Rather than modifying one item and holding everything else uniform, truly useful "what if" analysis holds only one premise constant (*e.g.*, sales or working capital), and allows all other factors and relationships to vary. Only then can line managers dissect task-specific value-adding strategies from the many possible means of improving a company's EVA.

Finally, some compensation experts calibrate award levels by publishing statistical summaries of industry-wide performance measures, and then incorporating "confidence intervals" into the plan's hurdles. What this boils down to is applying a uniform statistical measure like standard deviation to an intrinsically non-uniform, moving distribution like EVA. The prescription is not remedial. Measures like EVA are functions of so many diverse (often discontinuous) variables that they are seldom, if ever, distributed evenly, and they almost always have lop-sided tails. They are also moving targets. To date, there has been almost no attempt by compensation experts to measure and manage this uncertainty directly, yet it is imperative if compensation packages are to really "pay for performance."

***Business expertise is the answer.***

At the center of the implementation void is a chasm between compensation "expertise" and business know-how. Although performance measures and broad design features can be generic, many implementation tasks cannot. To make implementation work, the compensation expert needs a strong sense of the business circumstances attending a particular strategy. Only then will he or she have:

- ☑ a sense of how difficult the hills are to climb;
- ☑ a sense of management's discretionary contribution to share value;
- ☑ a way to differentiate performance within business groups; and
- ☑ a way to relate aggregate performance measures to identifiable management tasks.

Until recently, there was simply no substitute for experience—hence, the nagging suspicion among line managers that shareholders would have been better served by traditional subjective practices.

The rub is, objective performance measures haven't been given a fair chance. By glossing over questions of calibration, differentiation and integration, compensation consultants have set objective measures up for an undeserved fall. Residual income, or its popular incarnation, EVA, may be destined for the dustbin—not because it is a poor idea, but because it is a good idea poorly executed.

It's not too late. The chasm between line managers and corporate personnel (and eventually, compensation experts) can be narrowed. But it won't happen as long as line managers communicate their business options and prospects to corporate officers and outside experts using a static collection of "best," "worst" and "most likely" case scenarios. Nor will it happen if corporate officers and outside experts continue to describe the world to line managers as a series of hard-and-fast targets. The static case-oriented model of target-setting and performance measurement is simply inconsistent with a world that has come to accept orderly chaos as the norm.

***Build a model, not a plan.***

We believe plan design succeeds when it incorporates real-world uncertainty

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explicitly into the target-setting and calibration process. This is made possible when corporate managers develop probabilistic models, not individual forecasts, to describe their businesses. Such models modify performance targets to reflect changes in macroeconomic conditions beyond management's control—and do so in a manner which is widely understood and accepted in advance.

Such models also provide guidance as to the distribution of aggregate performance measures, since they can be run on a PC hundreds of times—allowing competitors' behavior and the economy to vary randomly, but in accordance with well-defined patterns. These distributions can be used to determine, for example, how steep management's hills are to climb, and thus how to calibrate an incentive plan.

In addition, the hundreds of simulations generated by a single probabilistic model will remind managers that there are many paths to the same EVA. A quick discounted cash flow comparison will reveal, however, that only one such path is value-maximizing. The database of simulations thus becomes a powerful practical guide for identifying which specific tasks and decisions of management are most consistent with increasing stock value—not just EVA.

Finally, the database of simulations shows how clustered value-enhancing patterns are, and thus each pattern's probability of attainment. It is quite possible, for example, for a value-maximizing strategy to be outweighed by a less ambitious, but far more probable, value-enhancing strategy.

### *This isn't rocket science.*

We recognize that phrases like "probabilistic," "PC" and "hundreds of times" conjure up images of mad scientists tinkering on sub-basement mainframes. The reality is much gentler. The power of off-the-shelf spreadsheets and add-ons has advanced so far that, for most companies, the transition to measuring and managing uncertainty is quick, cheap and intuitive.

### *Balancing Risk and Return*

Remember, stock prices and EVA are a function of expected returns *and risk*. But risk differs dramatically between the many growth options and operating tactics facing a business. To make meaningful choices, managers must build uncertainty into their cash flow projections, *not* their discount rate. Only then can they quantify dispersion and skewness in possible outcomes, and choose corporate strategies effectively. Pursuing an EVA-maximizing strategy based on a fixed cost of capital will not, by itself, ensure increased share value.

**Don't get us wrong. We love residual income and EVA, and are proud of our contribution to their development.**

It's just that calibration and target-setting are far more important, and too often overlooked, than choosing a precise measure of income statement and balance sheet performance—provided, of course, that whatever measure you choose charges the opportunity cost of capital against income.

We call our approach to implementation issues "Corporate Finance Re-Engineering," since it casts aside the traditional point estimate approach of corporate finance to deal with the daily brush fires of line management. Our second installment, "Distilling Order from Chaos," describes how corporate finance re-engineering can improve value-based planning, and thus ensure consistency between corporate strategy and incentives.

To obtain more information about this topic or our services, please call Pat Finegan at (212) 861-6052 or fax (212) 861-6811. Visit our website at: http://www.shareholdervalue.com.