The Pay-for-Performance Misnomer

A new study reveals that compensation at some S&P 1,500 companies might be determined by short-term, noneconomic measures instead of measures based on individual performance. Focus on the short term may lead to decisions detrimental to the firm.

A new study of Standard & Poor's (S&P) 1,500 companies by the Investor Responsibility Research Center Institute (IRRCi) finds "a major disconnect between corporate operating performance, shareholder value and incentive plans for executives." The IRRCi disseminates research on issues that intersect corporate responsibility and investors' informational needs. Its latest study explains that many of today's senior executives are evaluated on short-term accounting measures and the price of company stock. This obscures consideration of management's contribution to real long-term economic performance so that only 12% of the variance in CEO compensation is explained by performance of the entity.

In addition to the results of the study, I believe the corporate compensation committees of boards of directors and their consultants utilize self-determined non-Generally Accepted Accounting Principles (GAAP) accounting measures and low-ball "performance" goals to ensure payment of incentive compensation to executives regardless of whether the outcome is favorable for shareowners or whether the executive contributed to achieving the outcome (see "Hypothetical Earnings Drive Real Bonus Payments," *Strategic Finance*, November 2013).

Study Faults Compensation Methodology

The IRRCi study, "The Alignment Gap Between Creating Value, Performance Measurement, and Long-Term Incentive Design," describes the "overwhelming dependence of large U.S. companies on total shareholder return (TSR) as a dominant performance and incentive compensation metric." The report criticizes this practice because it doesn't recognize the cost of capital and also is subject to many vagaries that have little, if any, relationship to a single company's operating performance and the success of strategic decisions or the influence of executive management and the CEO. Extraneous factors include the level of the flow of federal funds into or out of the stock market, industry influences, commodity prices, and changes in regulatory rules.

One likely cause of the focus on specially defined performance metrics is the cap of $1 million on the deductibility of executive salaries contained in the Revenue Reconciliation Act of 1993. Bonus payments in any amount are deductible if they result from achieving previously established performance goals. Corporate bonuses paid to CEOs—some of the richest individuals in the country—are being funded by taxpayers. A further incentive to base much of executive bonuses on stock market performance is the tax preference given to capital gains earned in as little as one year. According to the study, overreliance on TSR and short-term accounting metrics distracts attention from the real drivers of economic performance and doesn't sufficiently focus on factors that CEOs actually influence.

Short-term Thinking

An important finding in the study is the preponderance of short-term measurements that are contained in many of the long-term incentive compensation program designs. Only 10%

of respondents' executive incentive plan designs define "long term" as three years or more. Nearly a quarter of companies have no long-term performance-based awards, relying instead on stock options and time-based restricted stock in their long-term compensation plans. This converts long-term into medium-term at best.

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The study found that nearly 60% of the S&P 1,500 changed their performance metrics used in their incentive calculations in 2013, which further reinforces and actually compounds the short-term thinking about "long-term" executive compensation. One-third of the companies changed 25% or more of the list of peer group companies they use for comparison in 2013, losing comparability over time. Despite the ostensible long-term nature of this portion of executive compensation, these actions highlight the short-term focus and desire of board compensation committees and their consultants to pay a tax-deductible bonus despite the reality of corporate economic performance.

Additionally, the research showed that very few companies use a measure of future value in their executive incentive design, which would include measures such as return on innovation, growth, and return from new product development and new markets. Focus on "making the quarterly numbers" in the short term may lead to decisions detrimental to the firm, such as deferring maintenance, curbing research and development projects, or failing to invest in new long-term strategies.

Economic Profit

Perhaps the most critical finding in the IRRCi study is that 75% of the S&P 1,500 companies have no cost of capital metrics or balance sheet data in the design of their long-term incentive plan. The report describes inclusion of this factor as a value-creating fundamental. This omission means that the most common measurement metrics used to evaluate the performance enterprises today and the design of long-term incentives to guide executive decisions don't necessarily align directly with underlying sustainable value creation for shareholders. For an enterprise to be sustainable in the long term, economic profit or economic-profit improvement must turn positive before capital and liquidity run out.

Economic profit, consisting of net operating profit after tax (or return on invested capital, ROIC) minus a charge for capital, is an enhanced and more effective value-creation performance measure because it takes into account the amount of invested capital as part of measuring overall value creation. It also facilitates thinking about sustainable value creation because it can be used to split a company's market enterprise value into current and future value. Only about 17% of companies specifically disclose the use of ROIC or economic profit as a determinant of long-term performance in their plan for setting the long-term portion of executive compensation. Today, more than 85% of the S&P 1,500 have no disclosed "line of sight" leading or process metrics in their proxy statements that are aligned to future value, innovation, and related drivers.

Based on their TSR and economic profit for the years 2008 to 2012, the S&P 1,500 companies can be split into four groups that represent a phase in the value-creating life cycle:

- 35.4% generated both a five-year positive TSR compared with their peers and a five-year positive cumulative economic profit (ROIC exceeding cost of capital). This is a positive sign that represents sustained growth and high performance.
- 17.3% had a positive relative TSR but a negative five-year cumulative economic profit. This is a positive sign that represents early growth or a turnaround.
- 17.9% had a negative relative TSR but a positive cumulative five-year economic profit. This is a negative sign that represents mature growth or harvest.
- 29.4% had negative relative TSR and negative five-year cumulative economic profit. This is a negative sign that represents a restructure or new business model.

Only about one-third of the companies in the S&P 1,500 qualify in the most desirable quadrant, yet generous bonuses seem to be paid to executives regardless of the economic performance of their company.

Actual Bonus Calculations

The final question answered by the research is, "How do companies *actually* design their compensation programs and calculate their executive bonuses?" Using a 10-year correlation analysis (2003-2012) of 1,200 companies over five-year rolling periods, the five-year geometric average realizable compensation for CEOs is $22 million. Variance from this average can be explained statistically by the following factors:

- Size of revenue, industry, inflation (44% variance);
- Economic performance, e.g., relative TSR five-year ROIC (12.4% variance); and
- Consistent company pay policy (19.2% variance).

The remaining 24.6% is not explained by known factors and could be the result of arbitrary decisions, frequent changes in plan provisions, and the like.

A 2013 study from Cornell and McGill Universities, "CEO Bonus: Alternative Performance Versus Gamesmanship," examines the managerial and economic consequences of using non-GAAP performance metrics to set bonuses. It also received a best paper award from the American Real Estate Society. The report has two important conclusions. The first is that "capital market participants also penalize [non-GAAP] manipulations, as firms with larger manipulation have lower market value and higher cost of capital, irrespective of whether these manipulative activities are driven by CEO bonus or other concerns." The second conclusion is that "external regulatory and market oversights are required to ensure fair reporting of non-GAAP information" when non-GAAP performance measures are used aggressively to determine CEO compensation.

Let's hope that more companies will do the right thing by discontinuing the use of misleading or noneconomic bonus calculations and instead make performance bonuses a reward for actual superior, sustainable economic performance. **SF**

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