

## Chapter 9

# Pay for Performance? Failure Pays Very Well These Days

**I**ncentive compensation has become one of the most emotive subjects in the business world. The gap between the compensation of top executives and the average employee has widened dramatically, but it is not just the size of executive pay packages that causes public and political anger—it is the perception that much of the money paid out is not really earned. The furor over bonuses paid to AIG executives after the company received more than \$160 billion (or \$1,400 from every U.S. taxpayer) from the U.S. government became an all-consuming political issue for Barack Obama in 2009. How could executives at a company seen as one of the primary instigators of the global financial crisis be so richly rewarded? In the UK, anger over former Royal Bank of Scotland chairman Sir Fred Goodwin's £700,000

annual pension, after the bank had to be rescued by the government, was front-page news for weeks. The apparent rewarding of failure points to serious flaws in the whole approach to the “pay for performance” compensation philosophy. Undoubtedly, increased scrutiny of pay will be one of the lasting legacies of the Crash of 2008. Naturally, Cruciant follows many of the “best practices” regarding compensation.

### **Fiction: January 2010**

In late 2006, Steve Borden presented a new incentive compensation plan to the Board. The aim of the plan was to focus incentives for the top management team on growth—specifically revenue growth. Cruciant had been growing its top line (sales) in the low single digits, so maintaining double-digit earnings growth was being achieved solely through cost reductions. Steve rightly saw that this could not continue. If Cruciant was to grow profits in the years to come, it needed top line sales growth in the 8 to 10 percent range. The new compensation plan tied incentives to achieving minimum annual sales growth of 8 percent. Below that level no bonuses would be paid. The Board loved it and quickly approved the new plan. Management was equally happy, because their internal projections based upon growth in the economy, the launch of some new products, and a couple of acquisitions virtually assured the target would be met.

Sure enough, come the end of the year, Cruciant posted an 11 percent sales gain, and managers were rewarded with rich bonuses. Strangely, the stock price did not increase by anywhere near the same amount. Analysts covering Cruciant commented that while the company had increased sales, it still lagged behind all of its major competitors, which had logged gains in the 13 to 17 percent range.

The Board was a little perturbed that rich incentives had been paid out even though the company had lost market share; however, they also could not argue that the bonus targets had clearly been met. Despite their concerns, the Board agreed to stay with the plan for one more year, because they liked the new growth culture that the plan had triggered. After years of low single-digit growth, the 11 percent increase was a big step forward. Unfortunately, the next year, 2008, proved to be very

challenging as the economy softened dramatically. After a solid first half, Cruciant ran into problems, and at year-end overall sales were down by 1 percent compared to the previous year. Under terms of the plan, no one received any bonuses. Ironically, not long after Borden left to “pursue new opportunities,” the Cruciant stock price moved up around 15 percent and analysts were praising the company for its exceptional performance in a terrible economy. All of Cruciant’s major competitors saw sales decline by more than 5 percent, and none came close to making a profit.

Not surprisingly, the announcement that no bonuses would be paid for 2008 was not met with much joy among the ranks. Within six weeks, seven of Cruciant’s top ten sales people had left to join competitors. New CEO Chuck Williams had to scramble to provide coverage of key accounts during the first half of 2009. The inevitable loss of momentum as a new sales team was assembled led to the company’s being unable to capitalize on the effects of the government stimulus package, and a number of opportunities to ensure the company gained a piece of the government pie were lost. Meanwhile the broader economy continued to worsen. Sarah, the VP of Sales, was working feverishly to hire new salespeople and get them trained. By the middle of 2009, Cruciant was forced to report that sales were down 7 percent even as their competitors reported flat or slightly improving sales.

By September, Sarah had managed to persuade three of the defectors to return, albeit for higher base salaries and guaranteed bonuses for the next two years. Around the same time, two of Cruciant’s customers approached Sarah to question some transactions that had occurred during the third quarter of 2008. Apparently, their auditors had highlighted a series of purchase orders that had been issued to Cruciant during the last two weeks of the third quarter of 2008. Upon further investigation it appeared that no actual goods had been shipped relating to the purchase orders and no payments were subsequently made. The POs in question had all been booked by one of the departed sales stars. As Sarah and Cruciant’s internal audit team probed further, it appeared that the saleswoman in question had persuaded the two customers to provide her with phantom purchase orders in order to boost her quarterly sales numbers. At the time, she was very close to making her target for the quarter and with the economy in freefall following the collapse of Lehman Brothers, she was desperate to stay on plan.

As the investigation continued, the story became murkier. Apparently, the saleswoman had paid purchasing officers at the two companies to generate the purchase orders; six months earlier she had purchased a high-priced condo in downtown Miami that was now worth only about 60 percent of what she had paid for it and considerably less than her outstanding mortgage; her monthly lease on the silver Mercedes 500 SLK was \$1,200 per month, and her American Express Platinum card had a balance of \$63,000. In 2007 she had been a star, netting a bonus of \$250,000; apparently 2008's bonus had already been spent, hence the desperate need to make the numbers. Cruciant's new CFO, James Morrison, pushed for an early settlement and managed to negotiate the fine down to \$600,000. The saleswoman is now serving a 19-month sentence in a low security prison in Kansas—her book chronicling the “culture of greed” that apparently pervaded Cruciant's sales organization is scheduled for publication upon her release.

### **Facts: The Great Incentive Scam**

An article in the *Harvard Business Review* commented, “The value that many superpaid CEO superstars supposedly created has largely disappeared, and the likelihood of it being recovered anytime soon seems remote.” The article went on to comment, “a good number of senior executives treated their companies like ATMs, awarding themselves millions of dollars in company loans and corporate perks. It's hard to dispute the idea that executives were somehow corrupted by the dazzling sums of money dangled in front of them.”<sup>1</sup> A pretty accurate commentary on executive compensation in 2009, except that the article was published in January 2003 and referred to the fallout from the dot.com bust, the meltdown in the telecommunications sector, and the raft of corporate accounting scandals that dominated the business news that year. Despite political outrage and public scorn, nothing much changed in the next five years.

#### ***So What Is the Problem?***

Describing the mess that is pay for performance could fill a very thick, and very boring, book. Suffice to say that the key elements of the story are greed, conflict of interest, and naïveté.

**Mythbuster Wisdom: Oh, the Beauty of Hindsight!**

A March 2009 study by the UK consultancy Oliver Wyman for the Institute of International Finance came up with two stunning statistics:

1. 98 percent of survey respondents believe that compensation structures were a factor underlying the crisis.
2. 95 percent of respondents have plans to increase the alignment of compensation delivery with risk.

I wonder how many would have agreed with the following statement from the report if it had appeared in March 2007?

“Our compensation practices encourage our people to take on excessive risk which is likely to lead to a global economic meltdown in the next 18 months.”<sup>2</sup>

The principle of paying for performance is elegant and simple. Sport has done it for years. However, in the corporate world, the problems start with the most basic element. Most organizations still insist on setting goals, targets, or budgets that determine rewards. If performance meets or exceeds the standard, bounteous rewards will be paid out. Once this principle is adopted, the rot has already set in. It is both naïve and stupid to believe that a fixed performance target set months, or sometimes years, in advance of the measurement period will remain relevant given the uncertainty and volatility that are inherent in today's world. However, this is not the only problem. The setting of fixed incentive targets destroys what should be one of the most valuable of all management processes—planning.

Planning is supposed to be an exercise in developing tactics, allocating resources, and optimizing performance to meet strategic goals. As soon as people understand that their personal rewards will be tied to the outcome, it immediately becomes a game to negotiate a set of performance targets that set the lowest bar possible for maximizing compensation. As Jeremy Hope and Robin Fraser commented in their book *Beyond Budgeting*, “The extent of gaming the numbers has risen to unacceptable levels.”<sup>3</sup> Again, they wrote this in 2003.

The fatal flaw is that payouts are tied to meeting some fixed target that is the result of a negotiation process that is completed long before the end of the measurement period. As all participants in the process are fully aware that the agreed-upon numbers will set the threshold for their individual payouts, there is no incentive whatsoever to develop a plan that optimizes performance. Hence the games begin. Using tactics that resemble a Cold War negotiation, participants bring the full array of tools to bear including, but not limited to, bluffing, lying, cheating, blackmail, and extortion to ensure that the chances of being richly rewarded for mediocre performance are maximized—and it's not even a fair fight. The board of directors, which is theoretically charged with safeguarding shareholder interests, is usually made up of friends of the CEO; the consultants they engage to advise them are seeking to sell large amounts of additional work to the company and therefore wish to keep management sweet; and the management team clearly wants to ensure they are richly rewarded for their effort if not their performance. The result is a system that in today's over-hyped incentive culture frequently rewards failure.

Many recent ex-CEOs were fired, or left to “pursue other opportunities,” and found that rather than being punished, they had won the lottery. Bob Nardelli walked away from Home Depot with \$240 million, Stan O'Neal left Merrill Lynch with \$150 million, and Chuck Prince got \$30 million from Citigroup. The relationship between pay and performance is not broken, it is inverted—the bigger the screw-up, the bigger the pay-off.

Unfortunately, this phenomenon is not restricted to the most senior executives, although they do get the biggest payoffs—funny how that works, isn't it? All across the corporate world there are managers and employees being rewarded for below average performance and being punished for exceptional performance—the exact opposite of what a rational compensation system should be doing.

Basing incentive payouts on whether an individual or organization meets a predetermined target or budget is not just daft—it is dangerous. There is the very real risk that tying incentives to meeting fixed targets or budgets achieves the exact opposite of what was intended by rewarding poor performance and punishing outstanding performance.

Yet most companies tie management incentives to some type of fixed performance target set months or even years in advance. There are three big problems with this approach. First, conservatism or sandbagging becomes pervasive as all participants engage in seeking to negotiate the most easily achievable target thereby maximizing the chances of earning all the available incentives. Jack Welch, former CEO of General Electric described the impact this way: “It sucks the energy, time, fun and big dreams out of an organization. It hides opportunity and stunts growth. It brings out the most unproductive behaviors in an organization, from sandbagging to settling for mediocrity.”<sup>4</sup> But this is not the biggest problem! Consider the following two scenarios.

- A.** If the overall market assumptions built into the plan are overly pessimistic and actual performance greatly exceeds planned performance due to a booming market, incentives may be paid that were not really earned. For example, if the plan for next year calls for 10 percent growth, incentive payouts will be tied to meeting or exceeding that number. If at the end of the year, actual results show a 15 percent gain, everyone is a hero and gets a big bonus, right? But what if the market grew 20 percent? Did they really perform so well or just have a bad plan?
- B.** Consider the reverse situation in which many companies found themselves in 2008. Again, assume the plan called for 10 percent growth, but this time the economy soured dramatically after the plan was developed. By the end of the year, the organization was barely able to eke out any gain at all. Obviously, everyone failed miserably and no bonuses will be paid. But what if all the organization’s competitors reported negative growth? Did they really do such a poor job? After all, isn’t one of the hallmarks of a great company the ability to outperform in the toughest of markets?

So there we have it; most incentive systems motivate people to promise little, reward them when they deliver on those promises, and punish them when they perform like heroes. As my American friends would say, “That’s oh for three, baby.”

But wait—it gets worse.

**Mythbuster Wisdom from Al Dunlap**

Al Dunlap, former CEO of Sunbeam, a company he destroyed, was for a brief time one of America's highest profile CEOs. Al was not shy about giving his opinions. In his book *Mean Business* (Random House, 1998) he described his philosophy on executive compensation: "The best bargain is an expensive CEO. . . . You cannot overpay a good CEO and you can't underpay a bad one. The bargain CEO is one who is unbelievably well compensated because he's creating wealth for the shareholders. If his compensation is not tied to the shareholders' returns, everyone's playing a fool's game." Al did not comment on whether CEO pay should also be tied to the destruction of shareholder wealth.

Not only are reward systems skewed toward mediocrity, some companies go even further. If managers fail to meet even mediocre targets, they will then change the rules to ensure managers can still be handsomely rewarded. Usually, this is explained away as being essential to retain talent, but how talented are they if the rules have to be changed in order to make sure they can afford the new Porsche? The late 1990s were a great time for reevaluating performance awards—some companies, including well-regarded companies such as Apple, Dell, and United Health went so far as to back-date the issue date of stock options to ensure a favorable, that is profitable, transaction for recipients.

During the 1990s, the stock option became the must-have element of compensation. Stock options were issued to employees at no cost to them. The options gave the employee the right to buy shares in the company at a fixed price over a certain period of time, typically ten years. So if you were granted 20,000 options at \$30 a share, you could buy 20,000 shares of stock for \$30 any time between the date of issue and the expiration of the option. Obviously, if your company's shares never made it to \$30, the options were worthless. However, as soon as the share price moved above \$30, you were "in the money." If the price went to \$45, you could buy 20,000 shares at \$30 for a total cost of \$600,000 and immediately sell them for \$45 each or \$900,000

and pocket a nice little profit of \$300,000. Many people made millions during the bull market that ran until the dot.com crash in 2000. Unfortunately, in the aftermath of the crash many others were left with options that were not just “underwater” (i.e., where the share price was below the price to exercise the option), they were drowning. No problem. Companies simply cancelled the old options and issued new ones with a more favorable exercise price. After all, we don’t want our wonderful team to be punished because the market crashed, do we?

### **A Personal Story—My Path to (Almost) Affluence**

During the dot.com boom years, a lot of people got very rich by exercising richly valued stock options—I was so nearly one of them. In 1991, I moved to the United States to help set up a consulting firm called The Hackett Group. We started with three people and managed to grow the business very successfully over the next six years. Over 90 of the Fortune 100 companies were our clients. In 1997, we sold the business to a venture capital–backed outfit called Answerthink. Answerthink’s strategy was to buy up a bunch of consulting firms, roll them up into one entity, and then take the company public and make a lot of money. It all sounded very simple and was a popular approach across many industries at the time. I well remember sitting through presentations that confidently predicted a run-up in the share price to over \$100 in the first two years as a public company.

At first things went very well. Answerthink went public in May 1998 with the shares priced at \$13 each. By the end of the first day they were up to \$15.44; not bad, but not great in those early dot.com-fueled days. I was fortunate enough to have received both shares in the new company and options to buy shares as a result of the sale of The Hackett Group. By the end of that first day I was already sitting on a nice paper profit. Unfortunately, that was all it was, as I was not allowed to sell any of the shares or exercise any of the options for at least a year. Both the shares and the options vested at the rate of 25 percent a

year for the next four years, meaning that while I sort of owned them already, I could not sell until they vested.

Over the next few months the share price steadily increased, and by January 26, 2000, the price had reached \$39.38 a share. By now 75 percent of my shares and options had vested, but I didn't sell any. That \$100 a share story was still rattling around my brain. Along the way I had accumulated more options, some were priced at \$28 a share and others at \$32 a share, yielding yet more paper profits. My personal balance sheet looked pretty good. Then came the collapse. One month later the shares were down to \$20.35; I did manage to sell a few shares on the way down but kept over 95 percent of my holdings. By May the price was down to \$14, barely above the offering price three years earlier. But surely this was only a temporary blip so I sat tight. By August 2002, the price was at \$1.57, and I was feeling pretty sick by now. As the price plummeted, I managed to sell most of my shares and at least get some cash out of the deal; as for the options, forget it, they were not just underwater they were swimming in the Puerto Rico Trench in the Atlantic Ocean.

I left Answerthink in late 2002, as my four-year "handcuffs" after the IPO expired; the share price was \$2.30. I left behind more than 50,000 stock options that had exercise prices somewhere between \$20 and \$40. Answerthink still exists, although in a move that was hugely ironic to me, the company was renamed The Hackett Group in 2007. This apparently recognized that Hackett was the only one of the many acquisitions that had any lasting value, which may explain the anemic stock performance. The name change did little to improve the stock price. In April 2009, the price was \$2.27, a loss of 3 cents of in six years.

Executive pay is a bit like politics. It is riddled with conflicts of interest, half-truths, and alliances of convenience as numerous interest groups vie for their piece of the pie. A good example is the role of compensation consultants who theoretically act as independent advisors

to a company's board of directors. Unfortunately, all too often the relationship is more akin to that of a lobbyist for a special interest group and a politician seeking to ensure that enough "pork" is directed toward their constituents. As one observer noted, "Compensation consultants know that if they win big pay packages for their CEO clients, they'll be rewarded with lucrative contracts to administer employee-benefits plans and the like."<sup>5</sup> Not exactly a recipe for objective advice.

As mentioned earlier, at the heart of the Great Incentive Scam is the process of rewarding people based upon meeting some mutually agreed performance target in the form of a plan, budget, or quota. As a result, planning is not an exercise in optimally allocating resources in order to achieve superior performance, but rather it is a warped and twisted negotiation of targets that subsequently govern incentive payments and performance reviews. This is how it plays out. The most desirable outcome for shareholders is a stretch target set to drive the optimal balance between risk and return.

Management's goal is to negotiate the lowest possible target in order to maximize the likelihood of earning the biggest possible bonus. The negotiation follows a predictable pattern. The CEO argues for growth using the time-worn phrases such as the need to maintain last year's momentum, leverage the value of past marketing and new product investments, exploit weaknesses in key competitors, add some great new products to the portfolio, and expand into a few new markets. Managers caution the CEO that last year's success has heightened the awareness and focus of competitors, the new products and markets will have a "ramp-up" period before they reach full potential, existing customers have limited capacity to increase order volumes, and economic uncertainty clouds the overall demand picture. After a few weeks of this horse-trading, the result is a compromise that satisfies no one and is almost certain to bear little relation to what will actually happen as the few reliable facts that were available at the outset will have been manipulated, framed, and massaged in such a way as to be almost unrecognizable. The CEO is convinced that managers can do better, but he or she also wants them to "own" the target and be "committed" to its achievement so they compromise; management feels they have been pushed to agree to a "stretch" target a little beyond their comfort zone,

but at least they were able to negotiate the CEO down from the original target.

Defending the indefensible is one of the core skills for any budding chief executive. We will discuss the art of spin in business in chapter 16, but for the time being all you need to know about defending excessive pay packages is to use one or more of the following phrases: “Pay is in line with the industry” or “Compensation is determined independently by the board of directors” or arguing that the total package “represents the cumulative reward for many years of outstanding service” and that it is “essential if we are to retain the best talent.”

Most of the time these empty platitudes work, but beware of coming up against a curmudgeon such as Warren Buffett who perhaps said it best: “Too often, executive compensation in the U.S. is ridiculously out of line with performance. The upshot is that a mediocre-or-worse CEO—aided by his handpicked vice president of human relations and a consultant from the ever-accommodating firm of Ratchet, Ratchet & Bingo—all too often receives gobs of money from an ill-designed compensation arrangement.”<sup>6</sup>

Some pay packages do not require spinning. In 2000, after returning to Apple in heroic style, Steve Jobs accepted no compensation but did get \$90 million to cover the cost of a nice, new jet. Unlike many CEOs, Jobs clearly earned his wings based upon Apple’s stellar performance in the years since his return. Apple shares stood at just over \$5 when he returned in 1997. By December 2007, they were at \$198, and even the crash of 2008 only brought them back to \$85 a year later, still seventeen times higher than upon his return. Jobs’ annual salary during that time was \$1. Not every CEO can claim the same return.

### ***So What’s the Fix?***

Fixing executive compensation is not difficult—in theory. After all, it simply requires common sense, rational calculations, honesty, and trust. In reality, it will always be an imperfect system. Any time you define performance over a fixed time period, there is a risk that actions will be tailored to maximize results within the time period, often at the expense of future periods. This happens with quarterly earnings, annual

results, and economic statistics, so it should be no surprise that results that drive rewards are “managed.” But there is another factor that is not always the result of conscious manipulation. Performance will vary over time, and there is a strong possibility that current performance will not be sustained. Sport offers a good model for this. Players and teams are largely valued on their past success. A championship season typically leads to higher attendance (and ticket prices) the next season. A player who performs exceptionally well is likely to be rewarded with a much richer contract for the future. But as we know, past success is no guarantee of future success so there are many instances of teams and players reaping rich rewards that are not supported by their subsequent performance. The reality is that the past is all we have so we must make the best of it.

In well-run sports there is a balance between rewards for past performance in terms of guaranteed money and incentives for future performance. However in America it seems that the trend is to more and more guaranteed money and less and less risk for the athlete—this is somewhat akin to paying for failure in the corporate world where rich payouts follow an executive’s termination. I may be biased, but golf, and tennis to a degree, seems to offer the best model. Professional golfers are independent contractors whose pay is determined almost solely by their performance. If you don’t show up or don’t play well, you don’t get paid. Even the rich endorsement contracts or appearance fees that the top players can command rapidly evaporate if their performance dips. There are one or two exceptions—attractive female golfers and box office stars like John Daly can command premium rewards not necessarily tied directly to their performance, but even that won’t last long if they fail to make it to the weekend in tournaments.

After the stock option scandals of recent years there has been a half-hearted attempt to redress the balance and actually introduce some measure of real performance into the equation, but old habits die hard, and very rich payouts for failure came to the fore again during the crash of 2008. Even some companies that tried to do the right thing then screwed it up. Shell, one of the largest oil companies in the world, had developed a measure that rewarded senior management if the company’s total shareholder return for the period 2006–2008 ranked in the top three in the industry—a sensible relative performance measure.

However, when the results were added up in early 2009, the French company, Total, had pipped Shell for the number three spot. Not to worry, said the company's compensation committee, management had worked really hard, and it was such a shame that they missed out by such a small margin, so we will give them half their bonus anyway. What's next, awarding half a bronze medal for finishing fourth at the Olympics?

The good news is that a growing number of organizations recognize the flaws, or are being forced to by their shareholders. The bad news is that if companies don't address the issues, then government will. The fix is not that complicated. The first step is to base incentives on performance-based metrics rather than plan-based metrics. For example, tying incentives to measures such as absolute performance improvement relative to prior periods or relative performance to a credible market benchmark or peer group can all but eliminate the motivation for games playing. General Electric talks about seeking out businesses that have the potential to grow at twice the rate of Gross Domestic Product (GDP)—an external benchmark that is difficult to sandbag. Using market benchmarks also allows for rewards to be structured in such a way that excelling in poor markets can be rewarded.

A number of companies are now including benchmark comparisons in their incentive process; others are introducing mechanisms to ensure that payouts reward sustained performance over an extended period of time rather than exceptional one-off performance. For example, starting in 2009, Swiss Bank, UBS will pay out rewards over a three-year period, and if it becomes apparent that the company's profits were unsustainable or an individual's performance was short-lived, payouts could be cut or even reduced to zero. Other forms of clawback will become more prevalent as companies seek to balance short- and long-term performance. Another important step that the collapse in the financial markets during 2008 brought home is that many companies were making significant profits, and therefore paying out huge bonuses, by taking on excessive risk. In most companies the management of risk and the setting of performance targets are poorly linked. Targets emphasize growth in sales and earnings, but how often do companies then analyze the likely risks associated with meeting the

targets? Part of the stress testing of performance targets demands that management ask questions such as:

- Can the targets be met without relaxing our credit risk standards?
- Is there a risk that our sales team will be motivated to ignore policies regarding promotions, pricing, and other incentives in order to make their quota?
- Can our suppliers or manufacturing operations meet the implied cost targets while still meeting quality standards?
- Are the growth targets consistent with our resource levels, or is there a risk that meeting the targets will negatively impact service levels?

Of course, these are exactly the questions that an effective planning process should be answering anyway, but as we have seen when pay is tied to plan, the words effective and planning can no longer co-exist.

The era of setting fixed performance targets for a year or more into the future is over—unfortunately, many organizations don't realize it yet. No one's crystal ball is clear enough to tie a significant portion of incentives to a fixed target or budget. While budget myopia persists, expect failure to continue to be richly rewarded for sometime to come.

## So What?

- Base incentive compensation on metrics that cannot be negotiated or sandbagged.
- Keep the rules consistent over an extended period of time.
- Balance short- and long-term performance.
- Always ask the question “are the risks associated with meeting the targets acceptable?”
- Ensure complete transparency of the calculation of rewards.
- Balance measures of absolute performance with measures of relative performance.
- Don't pay out rewards in one lump sum; stagger the payments.

**Notes**

1. Charles M. Elson “What’s Wrong with Executive Compensation?” *Harvard Business Review*, January 2003.
2. Institute of International Finance, “Compensation In Financial Services: Industry Progress and the Agenda for Change” (Washington DC: IIF, March 2009).
3. Jeremy Hope and Robin Fraser, *Beyond Budgeting* (Cambridge, MA: Harvard Business School Press, 2003), p. 8.
4. Jack Welch with Suzy Welch, *Winning* (New York: Harper Business, 2005), p. 189.
5. Harris Collingwood, “Do CEO’s Matter?” *Atlantic Monthly*, May 2009.
6. Chairman’s letter, Berkshire Hathaway annual report, 2005.