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Are Bonuses an Obstacle to Shareholder Value?

Despite the best intentions, most annual bonus plans motivate actions that inhibit the creation of long-term shareholder value.

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Why do companies pay annual bonuses to executives? It is presumably because they believe the bonuses will encourage executives to be more successful. And investors as a group view executives as successful if they maximize the long-term appreciation in the value of the company. But do executive bonus plans actually encourage long-term value growth?

Unfortunately, many do not. Bonus plans often encourage behaviors that inhibit long-term value creation. For example, many bonus programs measure earnings per share (EPS) or earnings before interest, tax, depreciation and amortization (EBITDA) against annually set targets. If companies are falling short of targets near their year end, many CFOs and other corporate executives take short-term actions that help them hit their annual goals but compromise their futures. For example, they could slash soft yet long-term-focused investments like marketing, R&D and training.

Most bonuses are based on how well performance achieves a budget. It is believed budgets help to set the targets right at the start of each year. Unfortunately, this removes any real emphasis on actually delivering results in terms of true multi-year improvements. That is because the expected profits from investments that take time to pay off are baked into future budgets, and profitable investment is not rewarded. This partially explains why many companies continue to under-invest.

Similar target-setting problems exist in the business units of companies too. In many companies, value-destroying business units have dire outlooks and are thus assigned goals that imply little value creation, while star businesses are assigned stretch goals. This enables value destroyers to earn as much or more in bonus than top value creators. As a result, any possibility of encouraging managers to think about opportunities and accountabilities that maximize long-term value creation is eliminated. The negotiation of the budget often has more impact on rewards than actual performance.

Another problem arises from the use of percentage performance measures. Over the past few decades, the use of profit margins and rates of return has increased. These "percentage" measures do a fine job of measuring quality. But they ignore quantity and can discourage investment, especially when they are prioritized above all else. A very strong business unit earning a 40 percent return on capital may be wrongfully discouraged from investing new capital earning a still-very-high return of 30 percent, since this would bring down the average return and reduce the bonus.

The problem of using percentages works in reverse for poorly performing businesses that earn, say, a 4 percent return. These businesses might be encouraged to pursue investments earning a below-the-cost-of-capital return of 6 percent or 7 percent because it would raise the average return, as well as the bonus. In both scenarios, the use of return percentages, especially when involved in bonus determination, leads to distorted capital allocation.

Are bonuses the only driver of executive behavior? Of course not. Fortunately, despite the prevalence of poorly designed bonuses, most executives do not deliberately destroy value for shareholders even if they would realize a financial benefit. Their integrity simply would not allow it. But why make them overcome the motivations implied by their bonus plan to make the right decision?

What about the influence of long term incentives (LTIs)? In most companies, the potential upside from LTIs materially exceeds the payoffs from annual bonuses, yet bonuses often garner greater influence. One study released by PWC last year shows that on average executives facing payouts spread over three years tend to value the collective sum at only 50 cents on the dollar.

So getting bonus design right is critical. And it is important to ensure bonuses do not become an obstacle to success.There is no panacea or perfect solution that can universally be adopted by all companies. To design the proper bonus scheme requires consideration of unique business factors such as the industry, business model, strategy, investment time horizon and corporate culture. Here are some guidelines that should be used for better executive bonus design:

1. Implement Better Measures

It's important to use one or several measures that properly balance revenue growth, cash-flow margin and asset efficiency. And it's best to ensure the balance between these measures is such that overall improvements almost always imply long-term value creation. One approach is to use a cash flow-based economic profit measure that tracks the cash generated in excess of the investor required return on gross assets employed. But other approaches work too.

2. Stop Measuring Against Budgets

It's crucial to start focusing on improvement year over year rather than using budgets as targets. This is possible with the more robust measures discussed above, where increases are almost always good. A focus on improvements reinforces the need to deliver results without excuses. It also frees up the budgeting and planning processes to function as the management tools they were intended to be rather than compensation negotiations.

3. Encourage Multi-Year Thinking

Committing in advance to the focus on improvements for multiple years promotes longer term thinking and better accountability. Executives would be rewarded well even if an investment causes a dip in performance as long as performance bounces back (and more) over time as the investment pays off. But if performance doesn't bounce back, the rewards decline.

4. Keep the Payoff Curve Simple

It's best to avoid steps, kinks and inflection points on the payoff curve that relates performance to bonuses. Every dollar of performance is worth the same but every time the slope changes or jumps it creates perverse incentives.

5. Ensure Consistency with LTIs

One should also avoid using measures in the bonus plan that conflict with the measures used, perhaps as performance tests, in long-term incentives. These conflicts explain why many executives have trouble understanding the linkage between performance and pay. With conflicting measures, the message many executives get is simply “do a good job." And since the bonus attracts disproportionate attention, often the better designed LTI is ignored.

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