Improving Managerial Behavior: A Better Plan for Success

By Gregory Milano

There is an accelerating movement to encourage corporate leaders to think and act longer term. Advocates such as Focusing Capital on the Long Term and Chief Executives for Corporate Purpose—alongside a growing chorus of investors, thought leaders and advisors—are encouraging managements to build enduring business models by emphasizing investments in the future that underpin the stability of the business, impact society for the better and reward all stakeholders.

Despite these initiatives and their broadening support, many managements continue to get mired in the quarterly earnings cycle and face other counterproductive practices that compromise the long-run health of their organizations. I covered this in the first chapter of *Curing Corporate Short-Termism, Future Growth vs. Current Earnings,* which was republished as Corporate Short-Termism and How it Happens in the *Journal of Applied Corporate Finance*.

With over three decades spent advising companies on strategy and execution, I've learned that change is hard. As it turns out, people don't like being told what to do. Who knew? Improving managerial behavior requires understanding how processes, conventions and financial incentives motivate undesired behaviors; and adopting new ways of doing business that clarify and reward sought outcomes.

Planning For Success

One of the more glaring and widespread management misbehaviors comes from what I call "paying people to plan for mediocrity." When we measure profits against a business plan, we encourage higher profits—but we are also encouraging lower planned profits. Boards counter that they do not accept what, in financial circles, are called "sandbagged" plans, which downplay expected results. But even when compensation committees call plans into question, it sets up confrontational negotiations and introduces another misbehavior: the incentive to withhold important information. One client recently referred to the arduous plan negotiations as *hand-to-hand combat*!

At most companies, this messy process occurs every year—that's just how it's done. But it's far better to use complete measures that can be compared to the prior year rather than a plan. This way, up is good, and down is bad with no negotiation. It takes some initial effort and intentionality to make this type of change, but it's an adjustment that can drive better alignment between management and shareholders' interests over the long term.

Measuring And Rewarding Success

Beyond the problems that come from measuring against the plan, there are other ways typical incentive designs promote bad behavior. Most companies use far too many, and incomplete, measures. Imagine a new investment or strategic initiative is expected to cause growth to accelerate, but margins and returns decline. Should bonuses rise or fall? It depends! Sometimes the result creates value, but pay declines, and vice versa. So how is this supposed to motivate value-creating behavior?

Data supplied by the S&P Capital IQ database and my organization's internal research into executive compensation indicate value-based incentives based on a single complete economic profit measure with targets set based on prior-year actual performance relate far better to total shareholder return (TSR) than the actual bonuses determined by the compensation committees. Using a complete measure and separating incentive targets from planning makes incentives align better with success than current practice. It leads to more rewards when things go well and more accountability when they don't.

While discussions in the media on incentives gone wrong usually focus on overpaid executives, it cuts both ways. Consider the software company Adobe Inc., which delivered 420% TSR over fiscal years 2015 through 2019, a performance that was over 2.5 times that of the S&P 500, according to

my company's calculations after reviewing Adobe's stockholder and proxy reports from 2015 to 2020. Yet, its average annual bonus payout was an average of 80% of target incentives over the five-year period.

Beyond the risk of managers making suboptimal decisions, companies in these situations are likely to have a hard time recruiting and retaining executive talent.

Accountability For Results

Often, short-termism persists even in companies that have fixed their performance measures and disconnected their incentive targets from the plan. Most often, this behavior can be traced to business performance and project look-back reviews. Consider the dialogue in a project review where the return on investment now appears to be 25%, which is below the 30% that was projected in the investment approval request. Most managers would be criticized for missing their plan, but the main message should be, “We are really glad you made this investment that earns a return more than doubling our cost of capital. We must figure out why our forecast was so high, but let’s not let that get in the way of celebrating that this investment created value.”

Accounting for True Value Creation

Accounting convention is problematic as well since many important long-term investments are expensed against current profits and are at risk of being cut when management feels the pressure to meet near-term earnings targets. Naturally, reducing investment in innovative R&D, brand building and even employee training weakens future performance. But down the line, management usually negotiates a totally new budget, so there is little downside for them, leaving shareholders to foot the bill in the end. While investments in intangibles have largely overtaken tangibles such as plant, equipment and working capital, imagine how much more innovation, brand-building and training investments would happen if they were recorded on the balance sheet as the investments they are.

Embracing Change

As we get going in the second half of 2023, management and boards will begin planning their incentive compensation changes for 2024. Now is the time to consider paying executives to think and act more like long-term committed owners. For those that do, their planning processes will return to being about planning rather than negotiating, and their executives will think longer term. Most importantly, they will be more likely to achieve top quartile TSR over the long term, which will make the company more fit and benefit all stakeholders.

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