Heresy on Executive Remuneration

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Blessed is he who has found his work;
Let him ask no other blessedness.

Thomas Carlyle, Past and Present (1843)

Abstract

Executive remuneration has increased exponentially in the last 15 years, but without a matching increase in corporate economic profit. The remuneration bubble seems to be explained by misconceptions and a number of re-enforcing feedback loops. Pay-for-performance schemes linked to accounting profit or share price re-enforce a paradox; the influence of executives on share price is grossly overestimated. Modern corporate governance demands publication of executive pay; this has shifted remuneration to higher, not lower levels. Behavioural economics has revealed that the link between incentive schemes, executive motivation and company results is tenuous at best and that there are numerous behavioural quirks that may lead executives to pursue and receive bonuses at the expense of corporate health. Perhaps it is time to consider executive remuneration "beyond bonusing".

Thomas Carlyle was an author and social commentator who referred to economics as the dismal science. In Past and Present, he sought a "conversion experience" in order to stimulate reform that addressed the problems and the consequences of the economic crisis of the 1840s. Sadly, many of these still afflict society: closure of businesses, loss of jobs, the growth of slums in industrial areas and the starving poor.

Executive remuneration is a relatively new and vexatious problem that is receiving considerable attention. Since 1980, CEO pay has been rising inexorably and exponentially. Since the mid -1900s, the escalation in CEO pay has tracked the steep part of an exponential curve. Between 1995 and 2000, there was a near three-fold increases in the ratio of CEO pay / company profit and, between 1993 and 2005, a similar increase in CEO pay / average pay. Particularly worrying has been the pre-recession worsening relationship between remuneration of senior executives and the economic profit of companies [1]. While there are exceptions to these trends, a recent headline reminds us of the continuing challenge: "Porsche CEO to receive golden parachute of $70m".

It is time to reconsider some fundamental notions that shape our mental model of executive remuneration, especially the axiomatic incentive schemes. Perhaps we are suffering the effects of conceptual snake oil and we need a "conversion experience" to reform executive remuneration.

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[1] M. Van Clieaf and J. Kelly. Strategic pay for future value. Corporate Governance Advisor 2005; 13(3); 1 – 11.

The Shareholder Alignment Paradox

The origin of this paradox is a dismal view of humanity and of the place of trust in business. This is the “principal-agent problem”: incentives must be devised to entice the agents (the executives) to act in the interest of the principals (the shareholders), who seeks a return on their investment in the company. Of course, there are costs and risks associated with appointing executives; there are also numerous potential benefits.

Executives have a legal and moral duty to decide and do what is good for the company. They are exhorted to align themselves with the interests of the shareholders… to “think and act like shareholders”. Although one could argue that they have a moral duty, paradoxically, shareholders have no legal obligation to do what is good for the company; they may do what is good for them. Somewhat belatedly, the advocates of codes of good governance are addressing the duties of institutional investors.

We create a re-enforcing loop in the paradox when we provide executives with incentives linked to the share price. Is the share price the interest of the shareholder? If not, then what is the interest? The answers are neither simple nor universal. If you are trading on a stock exchange according to share price dynamics or according to an investment portfolio algorithm, then your interest may be only the trend of the share price over time and its price when you elect to transact. If you are an executive with share options, it may be the share price when you are permitted to harvest; you might or might not also be interested in the capability of the company to create value in the future. If you are a caring long-term investor, your interest may be the share price, the intrinsic enterprise value in the long term and you will have a genuine interest in the way the company is run, in its strategy and in its reputation as a corporate citizen. If you are one of the Zildjian family associated with the eponymous 386 year old cymbal-maker “our legacy keeps us all focused on preserving the business for the long haul …. We’re guided by our core values - a focus on continuous quality improvement, innovation, craftsmanship, customer collaboration, empowering employees, avoiding complacency, and reinvesting in the company ... It’s just good management practice. We’d never want to be the ones to have to sell the company.”[2]

Dismal indeed are economics and business if we must entice capable executives because they are not internally motivated or because their jobs are unattractive or because we cannot trust them to do honestly that for which they are remunerated or because the executives think they are entitled to some of the shareholders’ money.

Share price, Influence and Power laws

The ability of executives to influence the share price frequently is overestimated. In the short-term, the share price may be influenced by profit above market expectations, by notice of an intended acquisition, by announcement of the sale of an under-performing unit, by the buy-back of shares or by confirmation of a special dividend. In the long term, corporate value and the share price are influenced by interdependent factors such as

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[2] A Formula for the Future. An interview with Craigie Zildjian. Harvard Business Review, July 2007

consistent delivery of superior return on invested capital, being an attractive company to work for, investment in innovation and new capabilities and a reputation of being a good corporate citizen.

Executive incentives usually are linked to share price and/or profit. Contrary to popular belief, accounting profit, expressed as earnings per share, correlates very poorly with share price. Return on invested capital is much better. Probably, EVA® is the best financial predictor. Across all industry sectors the prediction from EVA® still only accounts for 50% of the share price[3]; the balance is due to a variety of external factors over which executives have little influence. Even the level of EVA® achieved is influenced by numerous internal and external factors, the executives' control or influence over which also frequently is overestimated.

Even though the plot of a share price over time looks random, it follows the power law distribution described by Pareto (popularly interpreted in business as the 20-80 principle).[4] This frequency distribution of the price of a share is determined by numerous interdependent factors (as opposed to independent factors) that influence the price. So what? The power law distribution means that large fluctuations in share price occur much more frequently than we predict from the statistics of independent, random events … in which most executives have been educated. For example, a one-day 10% decline in the value of a share is predicted to occur once every 500 years by statistics based on the randomness of large fluctuations in share price. The power law relationship suggests a 10% decline once every five years.[4] What should trouble us is that large scale fluctuations are likely to occur once or twice in many long-term share incentive plans; furthermore, it is difficult, if not impossible, to predict the timing of these share price discontinuities and, usually, they are due to a multitude of converging factors, many of which are outside the influence of company executives. This is the world of the investor on the stock exchange, should it be the world of the executive employed to run the company?

Good Governance and the War for Talent

Remuneration has increased dramatically since the introduction of the codes of good governance, most of which included recommendations on executive and director remuneration. Is this cotemporaneous or cause and effect? Most codes recommend a pay-for-performance element in the remuneration of executives. Consequently, incentive schemes proliferated in the expectation they would lead to an improvement of company results. Unfortunately, executive total remuneration increased very much more than the economic profit of companies.

Traditionally, employee remuneration has been confidential. Now boards are required to publish their remuneration policy and even the remuneration details of executive directors and even other senior executives. The optimistic expectation of the authors of governance codes was that this would prevent lavish increases in executive remuneration. It did not. Publishing this information informed executives of what others

[3] Joel Stern. How to ensure executives are fairly remunerated. Finweek. September, November 2006. EVA® is a trademark of Stern Stewart & Co.

[4] Mark Buchanan. Power laws. Strategy and Business; reprint No. 04107

were receiving. Total remuneration shifted predictably, not to the lower end of the range, but to the upper end. This has been the unintended consequence of well-intentioned, but naïve plans to curb rising executive remuneration.

Additional fuel was provided by the notion that there is a "war for talent" and, therefore, a need for companies aggressively to attract and retain good executives. To meet this need, the focus of directors became remuneration schemes that would entice capable executives to the company and that would align them with the shareholders. In order to justify the increasing cost of remuneration and to appeal to their desire for large bonuses, executives were challenged to meet unrealistic expectations of continuous profitable growth. The executives were expected to achieve this while conquering tough global competition, complying with increasingly numerous and complex regulatory requirements and in an environment of other macro-economic factors over which they had little influence. Popular books by gurus catalysed the pursuit of unrealistic goals. Executives responded by trying to "shoot the lights out". Executives started to burn out fast (the tenure is approaching a mere five years), creating a shortage of available talent. Consequently, executives demanded higher remuneration and large bonuses to compensate for the challenges they faced such as heightened public attention, outrageously long work hours, meeting unrealistic expectations of profitable growth, stress and a likely short time at the top. This created yet another re-enforcing loop that took executive remuneration on its exponential trajectory.

Tokens and Sweat-Shirts Influence Behaviour

The token effect is well known to behavioural economists, but little appreciated in executive remuneration. For example, to good causes some executives voluntarily will donate tokens, such as time or artifacts, but not money. Dan Ariely[5] has highlighted a darker side of economic tokens. For example, when the temptation to cheat is separated from direct financial reward (cash) by a token, the incidence of cheating doubles! Shares and share options are tokens. This is not to suggest that executives cheat because of share schemes. The point is that, merely because they are tokens and not cash, shares and share options may influence demands, decision-making and behaviour of executives in ways that are differently from the influence of cash as a bonus which, in turn, is different from the influence of cash as base remuneration.

The *sweat-shirt effect* is also well known. If everyone else who is wearing sweat-shirts with the same logo is doing it, it's okay for me to do it. If my industry peers cut the R&D budget in order to make this year's profit budget (and bonus), it's okay for me to do so. If other companies in the industry are offering share options, then so shall we. This may even have perverse effects on teams of executives who might be tempted to go for the bonuses instead of doing what is good for the company. These are dismal considerations.

Pay For Whose Performance?

At issue here is John Donne's notion that "no man is an island unto himself". The superior results executives are considered to have achieved and for which they receive rewards are partly, and usually substantially, ascribable to the contributions and

[5] Dan Ariely. The End of Rational Economics. Harvard Business Review Reprint 0907H; also www.predictablyirrational.com

collaboration of others in and around the company. Other important contributors to individual and joint success are the enabling culture in which employees work and to the technological and other support systems. The glow of numerous "star" executives has waned on their moving to another company. In their previous place of work, their glow was not only incandescence, but also reflected light. When they moved to a new environment, they lost some of the intensity of latter … and, sometimes, even the former.

If all employees should receive rewards when results in the company are good, how should the rewards be divided? There are numerous possible solutions, some of which are: only to executives, equally amongst the members who have contributed, disproportionately more to the higher or lower salaried; *pro rata* the base salary; in proportion to the team's view on the contribution of each individual to the group's success. The challenge is not trivial: some incentive schemes actually demotivate individuals and even groups; some damage healthy collaboration between colleagues and between organisational lines of business, to the detriment to the enterprise as a whole.

The improvement in profit, share price or other financial indices, which is ascribed to executives, may have little to do with stellar behaviour of executives. Many executives received very large bonuses when profits and share prices soared when some commodity prices sky-rocketed and when the retail FMCG market took off due to readily available credit and. In the current economic decline, the opposite is likely to occur.

Motivation and bonuses

The *raison d'être* of executive incentive schemes is that incentives will motivate the executives to work harder or better and to deliver superior results to the benefit of the shareholders. Alas, this seems not to be so.

Controlled studies have refuted the link between results and executive rewards, except in the short-term. Perhaps, if the incentive scheme is a specially designed long-term plan, then the executives will be motivated for longer. Unfortunately this too is not so. Extensive studies, including a meta-analysis of 220 studies, have revealed the poor link between financial incentives and the results companies deliver: share "options …are a case of cherished belief trumping evidence, to the detriment of organisations".[6]

Despite the evidence, we continue to include incentives in executive remuneration – perhaps because of a combination of ignorance of remuneration "experts", a culture of entitlement amongst executives and the fear of directors that they will not be able to attract good executives if they do not offer incentives. Many executives and directors are convinced that the problem is not incentives *per se*, but the particulars of their scheme in order to "get the incentives right". This is a rich feeding ground for remuneration consultants. Alfie Kohn has vented his frustration: "trying to correct the

[6] Keith Leslie *et al*. Managing your organization by the evidence. McKinsey Quarterly 2006 (3): 65 – 75 **and** Aaron de Smedt et al. The link between profits and organizational performance. McKinsey Quarterly 2007(3): 6 - 8

trouble by revising a pay-for-performance program makes as much sense as treating alcoholism by switching from vodka to gin"[7].

Motivation has internal and external dimensions … and pay is not a very good motivator! Internal motivation has to do with the appealing nature of the work and with the work environment ("we do it because we enjoy doing it here"). Carlyle's views on work were similar to those of Confucius: "Choose a job that you like and you will never have to work a day in your life."

External motivation is different; it has to do with work as a means to an external reward, such as money. It seems that the simpler and more routine the task and the shorter the planning time horizon and the availability of results, the more likely are employees to be motivated by short-term by rewards. Executive work is not simple, not routine and time horizons should not be short. One can only wonder about the logic of long-term share options schemes that are extended to employees whose work focus is short-term?

The evidence suggests that the intrinsic and extrinsic factors are reciprocally related[3]: focus on the external reward diminishes the internal motivation. On the other hand, numerous studies have demonstrated that when employees work in a "great company to work for", they enjoy their work and the economic benefits to the company and its shareholders are very impressive: the return on invested capital is multiples higher than in the other companies. Companies are in the minority that recognise this relationship and use it to their advantage; most prefer to offer financial incentives of dubious benefit to the companies.

Bonus schemes may well motivate people … to receive bonuses[7]. So, when we issue shares options to executives, should we be surprised that they may do what they can to increase the share price, even at the expense of the long-term health of the company? So-called independent directors are meant to ensure this does not happen. They do not; their increased number on boards has had not beneficial impact on company results[8]. The long-term incentive plan also is supposed to provide correction for short-termism. It doesn't. The short-term wins hands down. Despite all the sophisticated engineering of short- and long-term incentive plans, 80% of executives will elect to secure short term profit targets by foregoing expenditure on projects with long term value[9]. Banking a significant portion of the bonus may, but will not necessarily, modify this behaviour; banking can also lead to resentment and a feeling of being coerced by golden handcuffs. In any event, the banked bonus is not necessarily a particularly good set of handcuffs. It is a bargaining item when the head hunter phones, which entrenches bonus schemes and further increases executive remuneration.

All Gain; Any Pain?

The promise of gain and threat of pain are used to manipulate, to "incentivise", people to do or achieve something. Frustrated by worrying trends in CEO remuneration, The

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[7] Alfie Kohn. For the best results, forget the bonus. New York Times October 17, 1993.
[8] R Leblanc & J Gillies. Inside the Boardroom. Wiley, 2005 and The Coming Revolution in Corporate Governance; Ivy Business Journal, September/October 2003. (Reprint # 9B03TE03)
[9] A. Rappaport. Ten Ways to Create Shareholder Value. Harvard Business Review, September 2006. Reprint R0609C

Economist called for less carrot and "more stick" [10]. Do we really want to use the threat of pain to incentivise executives or should we rather use the lure of gain … or both … or neither?

Share options and profit-linked bonuses are forms of manipulation for executives to gain by doing what will increase share price or increase profit. These may lead to good decisions and actions to increase company value in the long-term. They may also lead to decisions and actions to increase share price or profit at the expense of long-term company value. For example, executives may maintain high profits by reducing expenditure on people development, on improving the work environment and on innovation; they may delay increasing the capital employed in the company by delaying investment in necessary equipment maintenance or replacement; they may increase the company's gearing, which will reduce the weighted average cost of capital, increase the return on equity and, hopefully, increase the share price.

Another consideration is that most share option schemes are almost no-pain schemes. Options are issued and only paid for on exercising the call option; so, the worst case for the executive is not to exercise the option and, therefore, no gain. Failure to gain causes some pain: we feel punished or are upset if we do not receive a reward, especially if we did our best in the circumstances. Many very hard-working and good executives must be experiencing incentive pain in the current recession, because their share options are out of the money; what is this doing to their internal motivation? Not gaining from share options that were given us is far less painful than losing money for an option we purchased with our own cash. Should executives purchase their options in cash when they are issued, as must investors? Is this morally acceptable? What might be the unintended consequences?

"Blessed is he who has found his work;
Let him ask no other blessedness."

Thomas Carlyle's words on work challenge us to reconsider our ethics, our understanding of human behaviour, our philosophy of work, our ability to reconcile the dilemma of individualism and community, our approach to the work environment and our policies on executive remuneration.

Of course remuneration matters; most employees seek what they consider to be fair pay. When employees are asked what is most important to them about work, remuneration ranks behind factors such as opportunities for personal growth, non-financial recognition, great colleagues, stimulating work, an enabling culture and energising environment at work. When asked the same question, executives tend to rank money as most important to employees. The implications of this misperception are profoundly disturbing.

Sharing with executives the economic profit of the company is a seductive notion. However, the evidence is that bonuses are not great motivators and they may even do harm – some definitely do. Nevertheless, there is evidence that bonuses (self-) funded by profit, in excess of the cost of the capital employed in the company, can have salutary effects in some companies[4]. However, this is not a panacea.

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[10] Where's the stick? The Economist, October 9, 2003.

It seems we have created a number of re-enforcing feedback loops that have led to exponential increases in executive total remuneration, but not to commensurate increases in corporate economic or other outcomes. This is bad news. What's to be done? The only way to deflate the bubble is to interrupt or modify the interconnectedness … break the looping linkages and/or change the rules of connection.

A somewhat heretical approach is to abandon incentives. Very good executives should be very well remunerated: set executive's remuneration that is linked to the complexity level of their work (in the language of the Requisite Organisation[1]), the executive's capabilities, the enterprise complexity and expectations of future value to be created. Clarify the expectations of what the executive should deliver in the operational, strategic and reputation domains of the company. Then set about creating a work environment that stimulates and enables the executive to do what he or she genuinely enjoys doing. Remunerate them fairly. Acknowledge executives who respond well and deliver good results in the circumstances. Provide them with new and, perhaps, more demanding and complex challenges to match their capabilities and increase their remuneration appropriately. Is there a place for a bonus; neither an enticement, nor an entitlement to another person's property, but a gift distributed in an act of benevolence. Even this notion is problematic: a gift rather than a contractual right might offend; then there are the issues of its discretionary nature (like a tip to a waiter), its quantum and the proportionality of distribution. Perhaps it's wiser to bin the bonus and take our thinking on remuneration "beyond bonusing".

Do we really want in our companies the executives who require "top dollar" base salaries, attraction payments, retention bonuses, short-term bonuses, long-term (share option) incentive schemes and golden handshakes? If we do, we had better ensure delivery on our expectations and understand very well the behavioural traits of these executives and how to manage them[11].

Whatever we do, we need to deflate the remuneration bubble. Finding a good solution is not going to be a simple matter; the dynamic interconnectedness in human systems renders them susceptible to unanticipated behaviours and to unintended consequences.

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Abstract 125 words
Article 3 599 words

[11] Michael Maccoby. The Narcissist Leader. The Incredible Pros and Inevitable Cons. Harvard Business Review, 2004. Reprint R0401J