



# Good Governance and Compliance Require New Designs for Incentive Plans

## Identifying 'What to Measure' and 'What to Reward'

Companies need to align their variable pay schemes to their compliance systems and the values they stand for, so that the former will not impair the latter. As large organizations become more and more complex, reward programs should encourage behaviors that promote organizational success in more complex ways than those usually contemplated in the classic agency theory.



Corporate best business practice and compliance programs are typically based on the legal framework ruling company operations. However, in recent years, this approach has proved to be insufficient to prevent severe wrongdoing, and companies have been forced to turn to proactive programs to foster more ethical business practices. These programs go beyond strict compliance with current regulations. One of the essential tools today is good governance and ethical leadership by senior management. Through its everyday behavior, the top management should convey the message of the need to adhere to ethical practices and must adjust everyday

practices to match the core organizational values. Also known as “tone at the top,” this strategy conveys that a company is truly committed to the values proclaimed in its Code of Ethics, and that it is walking the talk and not just making meaningless ethical statements. It is not always easy for the senior management to follow this path as it calls for strong discipline and often requires acting on tough decisions. Yet, this is the only path that leads to commitment to a company’s Code of Ethics across the organization, as it builds an ethical discipline and also effectively avoids illegal actions and their damaging consequences to corporate reputation.



An issue that seems to consistently pose a challenge for this approach involves the design of variable compensation programs, which threaten the commitment of the business to ethics and jeopardize the corporate goals and core values in their attempt to secure short-term financial gains. Variable pay is usually tied to objectives associated with sales and market share growth, increased profits, dividends and company market value, as well as quantifiable short, medium and long-term targets – all combined in what is typically referred to as performance metrics. The makeup of the compensation schemes vary according to the responsibility levels: while a middle manager's pay often combines a 75% fixed salary and a 25% share of variable 'incentives,' top executives' fixed salaries normally account for 60% – at most – of their compensation packages, with the rest depending on their performance and accomplishment of specific goals. Monetary incentives may be granted in cash or equity (shares, stock options, etc.).<sup>1</sup>

In general terms, regular compensation plans reward managers for short-term results, whether these results turn out to be short- or long-lived. Particularly in the case of public companies, top management performance estimations tend to focus on company market value. The fact that a share of their compensation hinges on securing short-term results drives executives to seek immediate gains, even at the expense of long-term company value.<sup>2</sup> Specifically, with a typical equity-based compensation scheme, stock options are granted gradually over a specific period of time, and, once awarded, these shares can be sold by managers for cash. High percentages of variable pay, combined with short-term financial objectives, strongly indicate that immediate financial gain prevails over proclaimed corporate values. As shown by the recent

financial crisis, this scheme has but promoted the short-sighted quest for gains that ultimately undermine organizations' medium and long-term interests, casting serious doubts on top management's true commitment to compliance programs based on integrity and credible 'tone at the top'.

In Latin America (and other regions as well), the organizational structures of the multinational companies featuring local affiliates and regional headquarters makes it complicated to design the compensation schemes and incentive plans. In these scenarios, multiple executive roles are often assigned to a single individual (e.g., a local subsidiary CEO serving also as regional head), not only paving the way for potential conflicts of interests to enhance variable pay, but also showing strong interdependence among the drivers that determine objective metrics and escape managers' control.

Chronic issues stemming from the complex and difficult business environment in these regions further contribute to creating additional distortions when it comes to setting incentives. Executives might feel tempted to resort to unlawful means to achieve financial targets established in their compensation schemes – for example, increasing sales with dubious deals. As a result, in a setting where illegal practices are common, an inadequately designed incentive system can not only trigger a short-sighted search for results but also foster unlawful behavior in the form of acceptance – and creation – of corrupt practices, introducing both informal and shady incentives. Indeed, in environments besieged by endemic corruption, as is often the case in emerging countries, variable pay scheme design

<sup>1</sup> Young Stephen B, 2009b, "Board Guidelines for Setting CEO Compensation," Caux Roundtable Announcement, August.

<sup>2</sup> Bebchuk Lucian, 2009a, "Written Testimony, Hearing on Compensation Structures and Systemic Risk," June 11, Committee on Financial Services, US House of Representatives, [http://www.house.gov/apps/list/hearing/financialsyics\\_dem/bebchuk.pdf](http://www.house.gov/apps/list/hearing/financialsyics_dem/bebchuk.pdf).

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demands special attention and care to prevent undesired outcomes.

### The Need for Variable Pay and Income

Variable pay as an incentive has been traditionally viewed as an imperfect – albeit practical – solution to what is usually known as the “principal-agent” problem or “agency dilemma.” This notion encompasses the difficulties that arise under conditions of incomplete and asymmetric information when a principal hires an agent. This issue may surface in several employer-employee relationships, when agents pursue their own objectives and are inherently unable to loyally serve their principals. The “agency theory,” developed to analyze this crucial problem, provides a possible solution to align interests among principals and agents (for example, among an organization and its employees, or among shareholders and managers, or among executives and employees) by encouraging agents with monetary incentives based on the accomplishment of economic goals that reflect principals’ interests. As a result, compensation schemes have been designed to mitigate the agency dilemma as much as possible. Financial incentives have become a mechanism to ensure agents’ loyalty and commitment to their organizations’ strategic goals. A pervasive challenge for this approach lies in choosing the performance to be taken into account – that is, deciding whether to base incentives on past, current, future or expected performance.

Several currents of thought have refuted the principles underlying this approach, arguing that a system based exclusively on monetary incentives does not factor in satisfying the needs of others as an ultimate goal, thus undermining

the potential strength of moral values and commitment to organizational objectives. Material incentives ultimately indicate that the intended outcomes do not reflect a commitment to the organization but are reflective of the specific results rewarded by this system. A complementary approach to problems derived from exclusive monetary compensation schemes hinges on viewing them as results of inadequate program motivational premises rather than system design flaws. Hence, incentives may be construed as “extrinsic motivators” that do not change our behavior dispositions nor drive any sort of long-lasting commitment to values supporting future actions.<sup>3</sup> Monetary incentives would, therefore, have a temporary effect on professional performance, ensuring only a limited, short-lived compliance.

In this light, monetary rewards may be viewed as punishment, as they are actually manipulative in nature – that is, monetary rewards impose several conditions, which an agent needs to meet in order to accomplish certain goals.<sup>4</sup> Thus, punishment and reward are, in fact, two sides of the same coin: incentives may be highly desirable, but, as they depend on specific behaviors, organizations end up manipulating their employees-agents, while the experience of being controlled is likely to become punitive over time.

In turn, any reward system immediately tends to cripple intrinsic motivation: whenever something is presented as a prerequisite for something else – that is, as a means (performance) to an end (material reward) – the former will be viewed as less desirable and will, therefore, be undervalued. The downside of any such system is clear: as ultimate goals, material incentives curtail

motivation, rupture relationships, ignore reasons, discourage creativity and prompt excess risk-taking, and eventually undermine agents’ interest.<sup>5</sup>

A parallelism may be drawn between the conflicting tension between these two diverging principles – extrinsic, material motivation and transcendent motivation – and organizations’ external and internal missions. While an organization’s external mission points to the actual objectives and needs it is bound to meet, its internal mission involves fulfilling the actual needs of other stakeholders – that is, building unity and promoting mutual trust among organization members.<sup>6</sup> Explicit incentives are typically designed to make sure that the organization achieves its external goals. However, the organization can only attain long-term sustainability if, at the same time, it lives up to its internal mission – in other words, creating strong ties among its members, based on common values and mutual trust (transcendent motivation). As a result and as opposed to formal control systems, the notions of organizational ownership and loyalty become instrumental.<sup>7</sup>

### Solutions for Overall Incentive Programs

To avoid the negative effects of monetary rewards, several solutions have been devised both through phased monetary incentives and by means of broader, non-monetary rewards based on non-quantifiable metrics. There are five types of possible solutions available:

<sup>3</sup> Kohn Alfie, 1993, “Why Incentives Plans Cannot Work,” *Harvard Business Review*, September-October, pp. 2-7.

<sup>4</sup> *Ibid*: 5.

<sup>5</sup> *Ibid*: 5-7.

<sup>6</sup> Pérez López JA, 1993, *Fundamentos de la dirección de empresa*, Madrid: Rialp. Chapter 7.

<sup>7</sup> Rosanas JM and Velilla M, 2005, “The Ethics of Management Control Systems,” *Journal of Business Ethics*, Vol. 57, pp. 83-96.



◆ **Variable Pay Reduction to a Minor Part of the Fixed Compensation**

The purpose of this solution is to find a sound balance between both fixed and variable pay in order to ensure that neither is conceivable without the other one.

◆ **Setting Long-term Financial Targets**

This could involve sales volume, income, costs, EVA – for example, through a short and long-term bond split with an average 3-to-5-year term. In addition, it is convenient to extend performance measuring periods, taking into account, for instance, results over the past three to five years instead of considering only the last 12 month. Thus, incentives would be tied to accumulated, long-term performance rather than to short-term outcomes.

◆ **Long-term Payments**

This includes stocks that cannot be sold over a number of years. In this case, it is also advisable to separate the time when stock options can be cashed out from the moment they are vested. As executives cannot speed collection, this precaution prevents distortive incentives derived from their desire to do so.<sup>8</sup>

◆ **Decoupling Targets from Individuals' Control**

This is applicable both to overall company targets or region-specific targets. This can be very effective, for, when executives cannot control targets, they are not tempted to resort to shortcuts or wrongful behavior. This practice fosters cooperation and teamwork across the organization. It does not matter that this goes against the original rationale of the reward systems (additional

payments for individual accomplishments). In any case, the idea of controlling an organization's economic results is virtually an illusion in large companies' operations, since the influence on volume/income is arguable at best and often shared among several company areas, as illustrated by internal transfer prices, tax strategies, strategic priorities and resource allocations in headquarters-affiliate relationships, or global and regional value chains with local responsibilities only for specific parts. As a result, current discussions on performance focus on four drivers – control, accountability, influence and support.<sup>9</sup>

◆ **Introducing Qualitative Targets, including specific compliance goals**

A global study conducted by the headhunting firm, Egon Zehnder with over 1,000 executives from 13 countries, including Argentina and Brazil, on current compensation and incentive practices revealed that monetary reward systems increasingly coexist with young executives' rising appreciation not only for non-monetary metrics but also for motivational mechanisms that go beyond material rewards. As a result, survey conclusions seem to indicate that, for most participating executives, material incentives cannot “buy” motivation, and short-term rewards are making way to long-term incentives based on behavioral targets, particularly stressing the formulation of and compliance with codes of conduct.

There is also an increasing appreciation of job content over material compensations, as well as a preferred

choice for more interesting, less remunerative work over jobs offering more attractive compensation and less appealing professional challenges. Younger executives are showing greater interest in non-material job aspects, such as corporate culture or a healthy work-personal life balance.<sup>10</sup> Job features like greater accountability, more decision-making autonomy, and regular feedback are increasingly viewed as motivational drivers just as significant as or even more important than monetary compensation itself.<sup>11</sup> In 2010, a study on compensation carried out by Mercer in 120 US companies also found a growing interest in the adoption of non-financial targets, revealing a 17% increase in the introduction of such metrics in their incentive plans over the past year only.<sup>12</sup>

Despite the still strong prevalence of monetary incentive systems confirmed by the study, the rising importance attributed by executives to behavioral rewards tied to sound, non-quantifiable business practices points to a consistent tendency towards adopting a multidimensional approach to address compensation scheme issues. Both as regards incentives and targets, there is a trend towards incorporating elements associated with business practices, like perceived quality of compliance programs, implementation of code of conduct, etc.

Companies need to align their variable pay schemes to their compliance systems and the values they stand for,

<sup>8</sup> Bebchuk, Lucian, 2009c, “Fixing Bankers’ Pay,” *The Economist’s Voice*, November. 2.

<sup>9</sup> For more on this topic, see Robert Simons, “Designing Top Performance Jobs,” *HBR*, R 0507D-E.

<sup>10</sup> Egon Zehnder, 2009, “Reward – Seeking the Ideal Blend of Financial Compensation and Fulfillment,” Egon Zehnder International 6th. International Executive Panel, June. 5-7.

<sup>11</sup> *Ibid*: 10-12.

<sup>12</sup> Mercer, 2010, “The 2010 US Executive Compensation and Performance Survey,” [www.mercer.com](http://www.mercer.com), June.

so that the former will not impair the latter. As large organizations become more and more complex, reward programs should encourage behaviors that promote organizational success in more complex ways than those usually contemplated in the classic agency theory.

There are no ideal, foolproof solutions to offer in this field, but it is clear that any sustainable compensation scheme requires some of the options listed earlier – decoupling targets from jobs, reducing the number of targets to accomplish in extended periods of time, and incorporating qualitative targets as well.

◆ Common goals lower incentives to secure a reward through shortcuts or undesired behaviors, especially in settings where corruption is widespread.

- ◆ A limited number of targets facilitates the management to define them more objectively and measure them more effectively.
- ◆ Additionally, fewer targets allow for a more effective evaluation of organizational performance over a longer period of time, escaping the temptation to measure strategy success or failure over shorter time frames that can be easily tampered with.
- ◆ Assessments based on qualitative metrics provide a wider scope that captures in a more sophisticated fashion the true alignment between actions and organizational values. Some companies are already adjusting their incentive programs to these tenets.

<sup>13</sup> Bonime-Blanc Andrea and Brzezinski Marc, 2009, "Business and the Way of Democracy," *The New York Times*, December 27, 2009.

Just as authoritarian political systems have changed into more democratic government schemes over recent decades, the corporate world heads towards a transformation of similar connotations as a result of the recent global crisis. This change involves a substantial turnaround of a relatively opaque model focusing on shareholders' interests into a more transparent system that addresses the needs of multiple stakeholders, including middle management, employees, investors, customers and NGOs, among others.<sup>13</sup> The place and role of monetary incentives can be redefined to play a key part in the transition towards corporate strategies based on integrity and transparency. ☺

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