
3 EXERCISE

Executive Bonuses and Incentives

I. OBJECTIVES

- A. To help you understand the complexities involved in designing an executive compensation system that will reward performance in areas which are sustainable and result in long-term organizational success.
- B. To demonstrate the necessity to balance financial and non-financial criteria for executive compensation in both the short term and long term.

II. OUT-OF-CLASS PREPARATION TIME: 1 hour

III. IN-CLASS TIME SUGGESTED: 1 hour

IV. PROCEDURES

1. Read the entire exercise including the Background information below before class. After reading the Background information in the case, review information in your text or on the Internet on the topics of "Executive Bonuses" and "Executive Incentives."
2. Then, form groups of three to five students in class and answer the questions on Form 4.1 regarding a possible new design for an executive compensation system at Internet Applications. Once these questions have been discussed by the group and a group consensus (or majority opinion) on each has been reached, write your answers on Form 4.1.
3. The groups should then complete Form 4.2, which is partially completed for you but leaves space for additional short-term and long-term criteria for executive compensation. As you consider your plan, be sure to evaluate incentives that (if goals are accomplished) will make the company and its products sustainable over the long term. Add additional criteria as you see fit. Then, indicate for each criterion you retain what percent of total compensation should be based on each and how each should be divided among short-term bonuses and long-term stock options.
4. After completing Forms 4.1 and 4.2, the group should inform the instructor. When all groups have finished steps two and three, each group should have a spokesperson orally summarize their recommendations, the rationale for them, and their potential downsides for the entire class.

BACKGROUND

Internet Applications is a medium-sized computer software company that has grown rapidly since its inception 20 years ago in a large Texas city. While the company has had its "ups and downs" over the 20-year period, it has grown to be one of the top 1,000 U.S. companies in terms of total revenues. The company is currently doing well financially with revenue and earnings growth per share each up approximately 10 percent over the past year. However, its stock price is still approximately 50 percent below its previous peak price of 48 dollars per share achieved 10 years earlier.

The board of directors consists of some local public officials as well as industry experts and financiers, many of whom are CEOs of other companies in Texas. The current CEO, Donald Tisdale, was appointed to the position three years ago. Recently, the board was

shocked to see their company and the CEO highlighted in the annual *BusinessWeek* survey, which listed executives who did the least to earn their pay in the last year. Among the factors sighted was the lagging stock price, earnings that were still below those achieved four years earlier before the "financial crisis," and a board that continued to increase the CEO's total annual compensation despite the lagging earnings and stock price. As a result, the CEO's total compensation was approximately 580x that of the average employee in the company.

The board has based its short-term and long-term CEO compensation on the earnings of other CEOs in the metropolitan area and in the industry. They have also relied on an executive compensation consultant who indicated the CEO's total compensation was well within industry norms. As a result, the board was insulted by the *BusinessWeek* article and felt inclined to write a defense of their pay practices. However, one member suggested they seek some additional information before responding in a formal way.

The board asked their human resource vice president, Henrietta Peach, to make a recommendation concerning this issue. She suggested the director of compensation, Ellen Bennett, should conduct a study of executive compensation and make recommendations to the board. Bennett agreed and has asked your instructor to assist in her research and future recommendations. Your instructor has asked each team in the class for their analysis and recommendations as noted in Forms 4.1 and 4.2 in this case.

Your instructor has also shared with you the following information that he and Bennett have discovered in their research:

- Executive compensation consists of five components with mean percentages in U.S. corporations as follows:
 1. Big salary (35%)
 2. Short-term incentives or bonuses (24%)
 3. Long-term incentives or stock plans (31%)
 4. Benefits (5%)
 5. Perquisites (5%)
- Greater use of both short-term and long-term executive bonuses and stock incentives among top and middle managers is associated with higher subsequent levels of profitability.
- There is a high level of current pressure from the Securities and Exchange Commission (SEC) as well as some large pension programs (TIAA-CREF and CALPERS) to better link pay and performance among executives. Toward that end, they have proposed guidelines for executive compensation. These pension funds have described executive compensations in many of the companies in which they hold stock as "Heads I win, tails we flip again." As a result, they believe that excessive executive compensation dilutes stockholder equity and the returns of those who hold stock in the company. The problem is that in these companies executive pay is higher each year regardless of profitability, stock price, or meeting the needs of employees or customers.
- The late Peter Drucker, 20 years ago, indicated that executive pay was "off the charts" at that time. He recommended that the CEO total compensation should be no more than 20x the pay of the average rank and file employee.

- Current practices for determining executive compensation use competitive benchmarking by a compensation committee within the board of directors that utilizes comparisons with similar companies in terms of size, sales, industry, geographic region, etc. They also tend to use executive compensation consultants who have been recommended by other companies. Some critics have claimed that these consultants may have a conflict of interest in that boards tend to hire and re-hire those who “rubber stamp” their particular compensation preferences.
- CEO compensation among U.S. corporations is approximately 400x that of the average worker in these companies. This ratio is much higher than the same ratio in other developed countries. In fact, U.S. top executives are the highest paid in the world. This has created a “trust gap,” or a frame of mind, among employees that leads them to mistrust senior management intentions, doubt their competence, and resent their self-congratulatory pay. This issue has become salient when the same companies simultaneously engage in large-scale layoffs and downsizing. Research indicates that companies with higher pay differentials between executives and rank and file employees have lower levels of employee and customer satisfaction and declining market shares.
- Short-term incentives are usually given annually and may take the form of either cash or stock. Annual bonuses may also be based on achievement of specific objectives. Long-term incentives usually take the form of stock options used to link stockholder and executive incentives.
- Today the goal is to provide executive incentives that address the concerns of stockholders, employees, and customers. Companies that address all three stakeholders in their executive compensation tend to perform better in financial terms over the long run.
- Balanced score cards have been developed to provide a more comprehensive evaluation of the organization’s performance, taking into account not only stock price and financial returns but also employee satisfaction, customer satisfaction, market share, measures of product or service quality, innovation and product leadership, and low levels of employee turnover. The alleged benefits of balanced score cards are that they allow executives to focus on not only short-term financial results but also on factors which build future economic and non-economic success.