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EXECUTIVES CAN RESIST ANYTHING BUT TEMPTATION

There are many lessons that need to be learned from the economic crisis but there is one particular lesson that I want to talk about in this opinion piece. I want to talk about facing up to the reality that many executive bonus schemes provide too much temptation for abuse and in particular I want to talk about making sure that future bonus schemes do not repeat this mistake.
Now you might think that there is nothing original that I can add to this debate and to be honest until recently I thought that myself. I thought that the types of reforms that should take place are pretty obvious but a recent meeting made me realise that there is still an active debate surrounding these issues.

I was at a meeting with a non-executive director of an Irish quoted company and the topic of executive bonus schemes was on the agenda. To my delight the director said that the current bonus scheme that is totally linked to growth in earnings per share (EPS) was under review and a new bonus scheme was being considered. We were told that consultants had been hired and their recommendations would be considered within a reasonable time frame.
We were then asked what we thought about bonus schemes linked to Total Shareholder Return (TSR). (Readers not familiar with the concept of TSR can see an explanation at the end of this piece).
I expressed my opinion that TSR should not be used. I made it quite clear that I felt that it would be replacing one problem with a different one and that it would once again put a temptation in front of management that in the past they have shown themselves unable to resist.
I expressed the opinion that in the past bonus schemes linked to earnings per share (EPS) and using stock options tempted management to focus on managing EPS and share prices. I also said that if these schemes are replaced with TSR and stock options I believe that managing the company share price will be the temptation that executives will find hard to avoid.
I said that I believe that executives should be rewarded for managing the business and they should be incentivised over the long term. I also said that they should not be rewarded for simply adding to the risk profile of the company. I added that in the past too many executives took on risks in the knowledge that if it went wrong there was little downside but if it went right there was enormous upside.
I concluded by saying that I believe that bonus schemes should be primarily linked to some form of Return on Capital Employed (ROCE) or Economic Value Added (EVA) because this is how we can measure if they have managed the company well. If executives sustainably increase these I believe that in the long run shareholders will see this reflected in their share price.

Having expressed the opinion that TSR was not my preferred form of bonus scheme and having mentioned ROCE I was surprised to be told by this director that TSR is

generally being recommended by my peers. I was told that other institutional shareholders still wanted new bonus schemes to be linked to TSR and that using some form of ROCE was not the first thing mentioned by the consultants.
For some reason I have to admit that I had not realised just how widespread this move to TSR had become. I had not read about it in CFA magazines (Chartered Financial Analyst) or somehow I had missed other relevant articles. In fact I still have not got around to doing research into whether there is a major academic debate on this issue.
I did get around to looking at whether any companies use ROCE in their bonus schemes. A simple Google search threw up companies like Pearson, Cadbury and Northern Foods. (In fact these companies use a mixture of TSR, EPS and ROCE). This suggests that there is not a complete consensus on the subject.
Even though there is not a complete consensus it appears that TSR is currently pretty mainstream. Now that I know this to be the case I feel that I must write about why it is a mistake. I believe that we should learn from our mistakes. Mistakes will always take place but we should try to avoid making new mistakes and this means that bonus schemes should not be primarily connected to share prices.
I do not want to give the impression that using ROCE is perfect. There may be problems using it but until I discover what they are I will continue to think of it like I think about Churchill's quote that democracy is the worst system apart from all the rest. In other words I think ROCE is also flawed but it is not as flawed as EPS or TSR!

(Readers of my opinion pieces on Japan may think that I am being a bit hypocritical because one of my complaints about Japan has always been that Japanese executives do not care about share prices. I would just like to point out that I have always highlighted the fact that Japanese executives seem to care most about maintaining life time employment. This emphasis on "jobs for the boys" results in low Returns on Capital and this manifests itself in low share prices.
In future I will try to avoid giving the impression that I want them to care about share prices because what I really want is for them to care about ROCE)

In conclusion I just want to say that if any readers ever attend an AGM and if executive compensation comes up for discussion make sure that the directors know what type of bonus scheme should be in place.

Definition of Total Shareholder Return (TSR) taken from Answers.com:

Total Shareholder Return *(TSR) is a concept used to compare the performance of different companies' stocks and shares over time. It combines share price appreciation and dividends paid to show the total return to the shareholder.*