

## **BEST PRACTICES IN INCENTIVE COMPENSATION FROM THE PERSPECTIVE OF VALUE-BASED MANAGEMENT**

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### **Abstract**

As a consequence of the recent global financial crisis, the current economic environment emphasized the weak correlation between company performance and the incentives received by the management staff. Therefore, the existence and consistent implementation of best practices regarding the propelling of the management staff through incentives can lead to a tenable company development. The purpose of this article consists in studying existing methods of incentive granting from a value management perspective and in suggesting some alternatives that could be used by companies during a volatile period characterized by financial economic challenges.

**Keywords:** best practices, incentive granting, value management, economic value added

**JEL Classification:** G01, G30, G35, J33

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### **Introduction**

The financial economic evolution of the last four years has been characterized by uncertainty and precariousness, two direct effects of the global financial crisis. During such time periods, the creation of clear strategies and a consistent pursuit of their implementation can make the difference between bankruptcy and company tenable development. The large corporation's executives' appetite for taking short – term excessive risks with a view to reaching the performance indicators and, upon this basis, the procurement of important incentives, is considered one of the causes of the recent financial crisis that occurred within the US banking financial system and subsequently dispersed at world level (Stiglitz, 2010).

Best practices must have as main objective the avoidance of moral hazard manifestation. A suggestive example is the comparative analysis of the actual financial results and of incentive funds granted for the American investment banks (table no.1). Thus, although the actions performed by the investment banks' management staff did not trigger the reaching of performance targets, managers have received significant incentives paid in actual fact by the common American taxpayer through the TARP (Troubled Asset Relief Program) system operated by the American government. .

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**Table no. 1: The net results and incentive compensation in American banks, 2008**

Financial institution	Net result 2008 (profit or loss) - mil. \$	Incentive funds allocated - mil. \$	Number of employees	Net result per employee - \$/pers.	Average bonus per employee - \$/pers.	Total government support received / mil. \$ (TARP program)
Bank of America	4.000	3.300	243.000	16.461	13.580	45.000
Bank of New York Mellon	1.400	945	42.900	32.634	22.028	3.000
Citigroup	-27.700	5.330	322.800	-85.812	16.512	45.000
Goldman Sachs	2.322	4.823	30.067	77.228	160.420	10.000
J.P. Morgan Chase Co.	5.600	8.693	224.961	24.893	38.642	25.000
Merrill Lynch	-27.600	3.600	59.000	-467.797	61.017	10.000
Morgan Stanley	1.707	4.475	46.964	36.437	95.286	10.000
State Street Co.	1.811	470	28.475	63.600	16.505	2.000
Wells Fargo	-42.933	977	281.000	-152.786	3.479	25.000

Source: Cuomo, 2009.

### 1. The Agency theory

According to the agency theory, the rapports between the various participants in the company's activity are based on contracts, while the consequence of the enterprise's conduct is the effect of arbitrations and equilibriums between their specific interests thus allowing the analysis of the impact of various financial decisions, risk and profitability relevant, upon the earnings of all interest-holders (David and Petcu, 2008).

The agency cost theory (Jensen and Meckling, 1976) assumes that there is a contract – based relationship between shareholder and agent (the manager delegated to run the company) by which the latter is bound to achieve some specific targets. Nevertheless, if both parties wish to maximize utility, there is strong evidence to believe that the agent (manager) will not act in the investors' interest but in his own. In this respect, taking into account the informational asymmetry (the manager holds more information and takes current decisions on behalf of the investor), a moral hazard situation may occur if the manager's interests are not similar to those of the investors. Thus, an upstanding remuneration given to the agent (manager) is not, according to Jensen and Meckling, an optimal solution. This type of remuneration would make the manager draw away from the formerly established targets as his reward would be independent of his work quality (Eisenhardt, 1985).

Therefore the shareholder will try to limit the negative effects by offering incentives and bonuses, which make up the agency cost. Replacing fixed remuneration by bonuses that reflect performance is a much more efficient method for limiting these effects (Alchian and Demsetz, 1972).

Theoretically, the performance – related incentive granting decision has the role to reduce the agent’s impetus to draw away from the established targets and to diminish the moral hazard (Fama and Jensen, 1983).

## 2. Best practices in incentive compensation

The best practices in incentive granting strategies are based on the attitude of the organization members with a view to the achievement of the established target. In this respect, the „focus on participant” plays a significant role by trying to understand the psychological process of participant stimulation and motivation within an incentive granting program. The „focus on participant” theory is associated with Skinner’s ABC behavior model (Achievement Awards Group, 2007) (figure no.1).

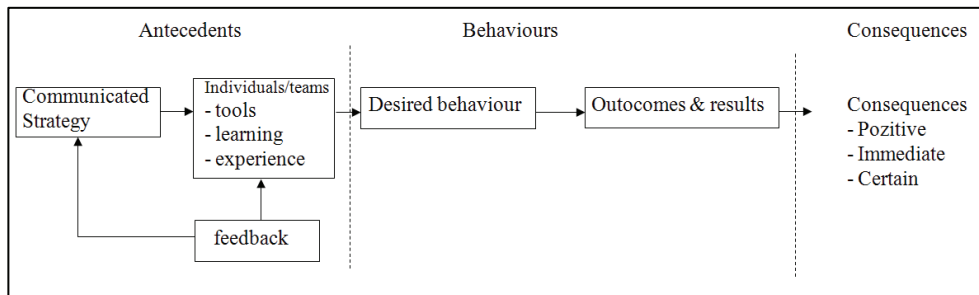


Figure no. 1: Skinner’s ABC Behaviour Model

Source: Skinner, 1957, p.124

Created by the behavioral psychiatrist B. F. Skinner (1957), the ABC model reveals the three categories of factors that positively influence the performance level, as presented below:

- The antecedents supplying people with the resources necessary for the achievement of performance targets. Communication abilities, knowledge and expertise allow for the identification of actions that must be performed as well as for the specific methods of implementation;
- Behavior consists in the set of actions adopted by management with the purpose of achieving the pre-established targets;
- Consequences must be positive and reflective of active types of behaviour while discouraging passive ones.

Behavioral changes are actually the effect of the answer that the individual gives to the signals (stimuli) manifested within the environment.

Young and O’Byrne (2000) present four basic objectives that companies must pursue with a view to realizing the incentive granting policies:

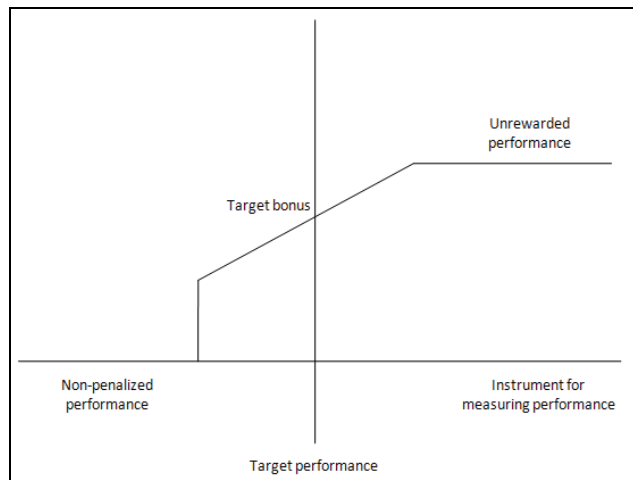
- Alignment: granting the management enough incentives for the choice of strategies and investments that may lead to maximizing the value for shareholders;

- Leverage effect (multiplying income for management): offering enough incentives for management staff in order for them to work harder, assume risks, make difficult decisions and maximize value for shareholders;
- Keeping: offering enough incentives for the management in order to keep them even in diminished performance for the company triggered by the evolution of the market;
- Cost for shareholders: limiting costs for shareholders in granting incentives for the management staff so that it may bring an added value for shareholders.

According to Martin and Petty (2000), the policies for incentives granting must answer three fundamental questions:

- What is the level of incentives that must be granted?
- What is the relationship between incentive granting and performance?
- What are to-be-paid incentives made up of?

In order to establish the incentives to be paid, one can follow the performance levels to be reached. Below (figure no. 2), we are presenting a general scheme establishing the relationship that exists between the granting of bonuses and the established performance.



**Figure no. 2: General scheme for performance- bonus**

Source: Young and O’Byrne, 2000, p.114

The main aim of incentives is, as we mentioned above, to solve the agency issue, making the management’s interests compatible with those of shareholders. The tools for incentive granting (types of bonuses apart from fixed remuneration) include: short-term bonuses, long-term bonuses, additional benefits (pension plans, health insurance etc.), shares, options, as well as other payment methods that vary according to each company.

### 3. Incentives Granting Systems and Indicators from the Value Management Perspective

Starting from the principle according to which the company's target determines the used measurement instruments and therefore the incentive granting policy, in the case of value management, at the core of the incentive granting policy there are well-known instruments: economic value added (EVA), cash flow return on investment (CFROI), market value added (MVA), total shareholder return (TSR).

Nevertheless, a problem occurs at this stage: choosing the appropriate performance measurement instrument that would not create a stimulus for the manager to draw away from the established targets. The choosing of performance measurement instruments implies problems related to the way the company management will concentrate on achieving the established target for the used instrument, and the lack of a global view on the general target of value maximization for shareholders being at the same time liable for the interested parties. The use of a performance measurement instrument and the establishment of an incentive granting system based on a different indicator may lead to negative results.

It is important that the performance measurement tool to determine the system of incentive compensation (Young and O'Byrne, 2000).

The performance measurement instruments that start from accounting results have the disadvantage of the management's easefulness of manipulation through the application of various accounting treatments: amortizations, provisions, etc. Thus, the achievement of such targets by managers does not mean value maximization for shareholders. Yet, the achievement of such targets can be a short-term one, thus sacrificing future potential increase. The second objective, leverage effect (multiplying the management's income) is a consequence of the obtained results. Thus, in 91.11% of companies the CEO that does not possess significant shares in the company must have sufficient incentives for the decisions that he makes to be in full accordance with the shareholders' expectations.

#### *General model of incentive granting*

A general method of establishing manager incentives, irrespective of the used indicator, is presented by Young and O'Byrne (2000):

$$\text{Incentive A} = Fr * Ars * (Vo/Vt) \quad (1)$$

in which:

Incentive A – granted incentive;

Fr – fixed remuneration;

Ars – assumed risk surplus as offered percentage, independent of company performance;

Vo – value obtained of indicator and

Vt – value – target of indicator.

Example:

Fixed salary (remuneration) in year N is 2,300,400 lei

Surplus for assumed risk is of 15%

The ratio between the obtained value of MVA and the targeted value for MVA is of 1.2.

Thus, the granted incentive = 414,072 lei

Total obtained benefits = fixed remuneration + granted incentive = 2,714,472 lei.

15.25% of obtained benefits represent the granted incentive (bonus).

Through this model, we can use whatever measurement instrument for value added closely related to the short and medium term company strategy.

*Using economic value added in the granting of bonuses*

The specialty literature offers clear examples of the way in which the EVA indicator is used in establishing the incentives granted for the company management and employees. The basic plan (Young and O’Byrne, 2000) assumes that the establishment of the incentives’ value for management to be calculated as a percentage of the economic value added.

$$\text{Granted incentive} = x\% * \text{EVA} \tag{2}$$

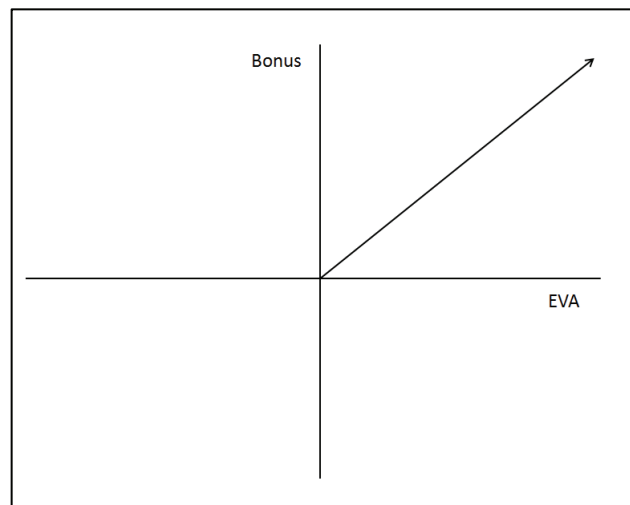
in which:

Incentive A – granted incentive (bonus);

x% - negotiated percentage of bonus and

EVA – economic value added.

This system also has certain disadvantages related to the negotiations of the incentive percentage. Thus, during value increase and creation, the percentage might lead to a much bigger incentive. On the other hand, a negative value of EVA would lead to no bonus granting. We have presented (figure no. 3) the graph version of this type of bonus granting system.



**Figure no. 3: The basic plan for bonus rewarding using EVA**

Source: Young and O’Byrne, 2000, p.135

Another issue refers to the target established for the economic value added. Bennet Stewart (1991) considers that negotiating the target for EVA is not a solution. On the other hand, revising this target yearly would be more useful both for managers and shareholders.

The equation suggested by Stewart is the following:

$$EVA_{t_{n+1}} = EVA_{t_n} + B\% (EVA_{a_n} - EVA_{t_n}) \quad (3)$$

in which:

$EVA_{t_{n+1}}$  – target for the economic value added in the year N+1;

$EVA_{t_n}$  – target for the economic value added in the year N;

B% - the percentage of the difference between actual EVA and targeted EVA required for the following year; it can have values between 0% and 100% and

$EVA_{a_n}$  – actual economic value added in N.

Example:

We assume that a company had in year N an attainment target of EVA of 1,500,000 lei. Thus, the new EVA target will be different depending on the percentage value of B% (table no.2).

**Table no. 2: The target of EVA for different levels of percentage B%**

EVA (N) (lei)	B%	EVA obtained in N - EVA(N)	EVA (N+1)
1.250.000	0%	250.000	1.250.000
1.250.000	10%	250.000	1.275.000
1.250.000	20%	250.000	1.300.000
1.250.000	30%	250.000	1.325.000
1.250.000	40%	250.000	1.350.000
1.250.000	50%	250.000	1.375.000
1.250.000	60%	250.000	1.400.000
1.250.000	70%	250.000	1.425.000
1.250.000	80%	250.000	1.450.000
1.250.000	90%	250.000	1.475.000
1.250.000	100%	250.000	1.500.000

At a 0% value of the B%, the EVA target will remain unchanged, but at a 100% of the B% the target increases by the difference between the actual EVA in the year N and the EVA target of the year N. (table no. 3 and figure no. 4)

**Table no. 3: Calculation of EVA target for a B% of 50%**

	N	N+1	N+2	N+3	N+4	N+5
<b>EVA (N)</b>	1.250.000	1.375.000	1.437.500	1.468.750	1.484.375	1.492.188
<b>EVA<sub>r</sub></b>	1.500.000	1.500.000	1.500.000	1.500.000	1.500.000	1.500.000
<b>B%</b>	50%	50%	50%	50%	50%	50%
<b>EVA (N+1)</b>	1.375.000	1.437.500	1.468.750	1.484.375	1.492.188	1.496.094

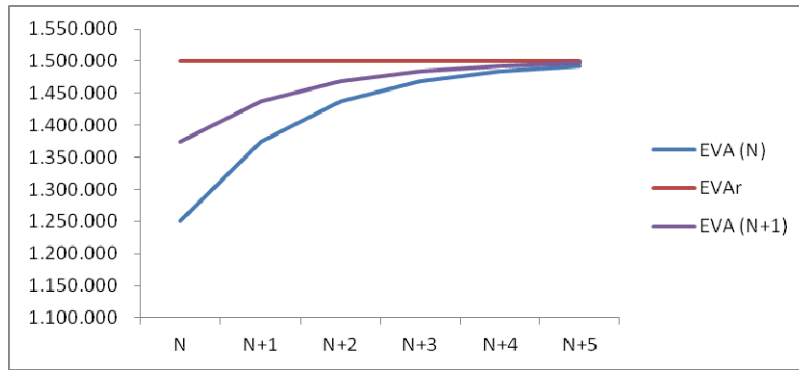


Figure no. 4: Target EVA for an unchanged achieved EVA

The same author asserts that the equation above could add a constant with either positive or negative values. The positive value of this constant will raise the target level for the economic value added in high competition conditions forcing the managers to make the decisions that are appropriate for the increase of EVA. On the other hand, in uncertain conditions one can take into account a negative value for the constant.

$$EVA_{t_{n+1}} = EVA_{t_n} + B\% (EVA_{r_n} - EVA_{t_n}) + \text{constant} \tag{4}$$

In which:

Constant – the extra value required by the management

Below you will find a simulation (table no.4 and figure no. 5) of the calculation of the EVA target for five years taking into account a positive level of the constant presented previously.

Table no. 4: The target of EVA with a positive constant

	N	N+1	N+2	N+3	N+4	N+5
<b>EVA (N)</b>	1.250.000	1.475.000	1.587.500	1.643.750	1.671.875	1.685.938
<b>EVAr</b>	1.500.000	1.500.000	1.500.000	1.500.000	1.500.000	1.500.000
<b>B%</b>	50%	50%	50%	50%	50%	50%
<b>Cons.</b>	100.000	100.000	100.000	100.000	100.000	100.000
<b>EVA (N+1)</b>	1.475.000	1.587.500	1.643.750	1.671.875	1.685.938	1.692.969



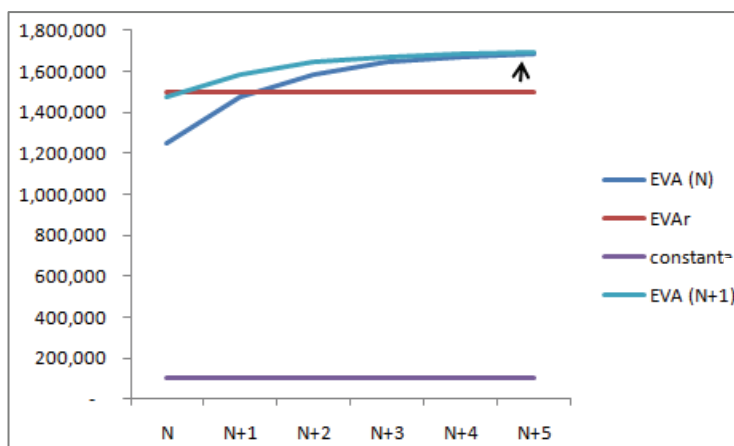


Figure no. 5: EVA target with a positive constant

The negative value of the constant denotes an excessively prudent level in establishing the EVA target, much below the actual value. (table no. 5 and figure no. 6).

Table no. 5: The target of EVA with a negative constant

	N	N+1	N+2	N+3	N+4	N+5
<b>EVA (N)</b>	1.250.000	1.275.000	1.287.500	1.293.750	1.296.875	1.298.438
<b>EVAr</b>	1.500.000	1.500.000	1.500.000	1.500.000	1.500.000	1.500.000
<b>B%</b>	50%	50%	50%	50%	50%	50%
<b>constanta</b>	-100.000	-100.000	-100.000	-100.000	-100.000	-100.000
<b>EVA (N+1)</b>	1.275.000	1.287.500	1.293.750	1.296.875	1.298.438	1.299.219

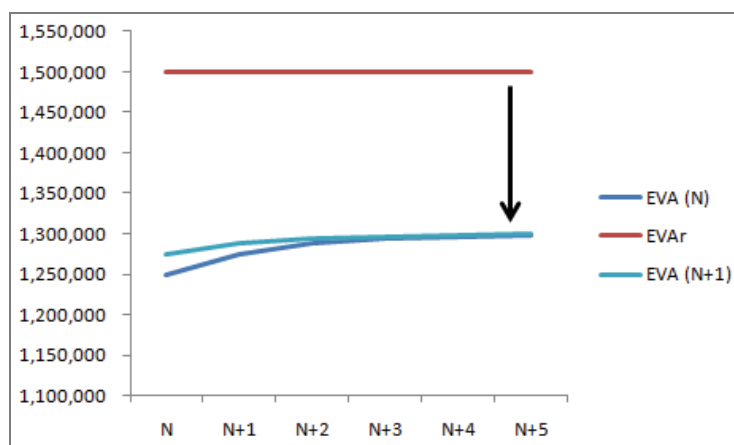


Figure no. 6: The target of EVA with a negative constant

*The use of absolute variation of the economic value added*

Another incentive calculation method (Young and O’Byrne, 2000) by EVA modification is the following:

$$\text{Incentive} = x\% * \text{EVA} + y\% * \Delta\text{EVA} \tag{5}$$

In which:

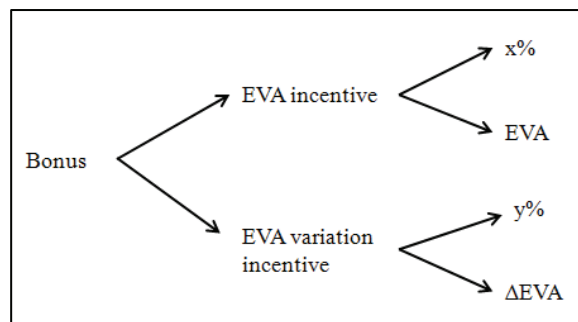
x% - percentage of the economic value added, if EVA is positive, and 0% if EVA is negative and

y% - percentage from the EVA modification. y% is bigger than x%.

Percentages are established in accordance with the required performance levels of each company. (table no. 6 and figure no. 7)

**Table no. 6: Calculation of the bonus through variation of EVA**

	N	N+1	Percentage variation
<b>EVA</b>	1.250.000	1.400.000	16,67%
<b>ΔEVA</b>	250.000	150.000	-40%
<b>x%</b>	1%	2%	100%
<b>y%</b>	6%	5%	-16,67%
<b>Bonus</b>	27.500	35.500	29,09%
<b>EVA incentive</b>	12.500	28.000	124%
<b>EVA variation incentive</b>	15.000	7.500	-50%



**Figure no. 7: Bonus calculation system**

The yearly modification of incentives was of 8,000 lei representing an increase of 29.09%. The incentive granted due to the EVA increase rose by 124%, thus limiting the effects of the incentive granted on the basis of the EVA decrease by 50%. An important role in the incentive modification is played by the two percentage values, x% and y%. Thus, x% doubled its value during the analyzed period while y% dropped by 16.67%. Even if the percentage values are materialized by the negotiation between shareholders and the management team, their establishment must be based on calculation and projection in order to carefully notice how calculation leads to performance increase.

The presented situation demonstrates the significance of the percentage establishment with a view to incentive granting as well as of the level of the granted incentives in case of high

performance levels. The multinationals that implemented this type of system even penalized management for negative levels of EVA or used „bonus banks”. Basically, if during one year, the management gets high performance levels, it obtains only a part of the incentive while the other part will be placed in an account and granted or withdrawn in accordance with the performance levels reached during the following year. This method determines an emphasis placed on value maximization and an increase of the long-term performance.

*The modern approach of incentive granting through economic value added*

The use of EVA in incentive granting for company management led to the development of the calculation method.

$$\text{Incentive} = \text{target incentive} + y\%(\Delta\text{EVA} - \text{EVA}_{\text{ma}}) \quad (6)$$

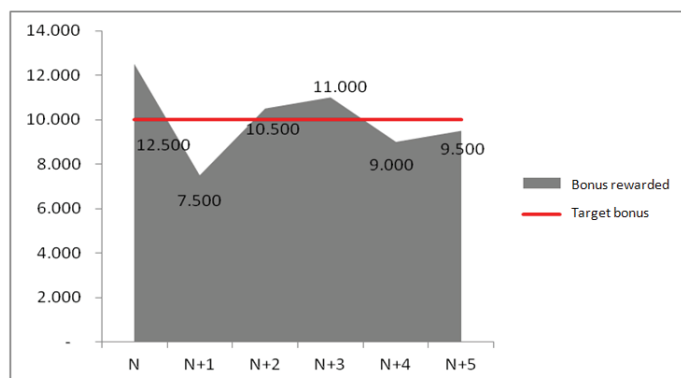
In which:

EVA<sub>em</sub> – expected modification of the economic value added

Below we are showing an example of incentive calculation granted for several periods (table no.7 and figure no. 8)

**Table no. 7: Calculation of the bonus based on the modern approach**

	N	N+1	N+2	N+3	N+4	N+5
<b>ΔEVA</b>	250.000	150.000	210.000	220.000	180.000	190.000
<b>EVA<sub>ma</sub></b>	200.000	200.000	200.000	200.000	200.000	200.000
<b>Target bonus</b>	10.000	10.000	10.000	10.000	10.000	10.000
<b>y%</b>	5%	5%	5%	5%	5%	5%
<b>Bonus rewarded</b>	12.500	7.500	10.500	11.000	9.000	9.500



**Figure no. 8: Comparison between the bonuses rewarded and target bonus**

*The use of the average economic profit indicator at the value of 1 leu of invested capital for the granting of incentives.*

Below we are proposing a calculation method for company management incentives which takes into consideration both the EVA indicator and the average economic profit at the value of 1 leu of invested capital. Imposing some conditions concerning the value creation is not enough unless the ratio between the economic value added and the invested capital is not included in the calculation.

The suggested model is:

$$\text{Incentive} = x\% \times \text{EVA} + (\text{ep} - \text{ep target}) \times \text{EVA}$$

in which:

$x\%$  - is the negotiated percentage for the calculation of the incentive as part of EVA

$\text{ep}$  - is the average economic profit at the value of 1 leu of invested capital during the current year

$\text{ep target}$  - is the economic profit target at the value of 1 leu of invested capital in the beginning of the year

The main condition for the incentive to be granted is that the economic value added should be positive. (table no. 8)

**Table no. 8: Calculation of the bonus based on the proposed model**

No.	Elements	N	N+1	N+2	N+3
1.	Invested capital	2.500.000	2.600.000	3.000.000	2.800.000
2.	WACC	0	0	0	0
3.	NOPAT	700.000	840.000	600.000	800.000
4.	Cost of capital	600.000	650.000	690.000	784.000
5.	EVA	100.000	190.000	(90.000)	16.000
6.	EVA/Ki	4%	7%	-3%	1%
7.	target EVA/Ki	5%	5%	5%	5%
8.	$x\%$	7%	7%	7%	7%
9.	Bonus	6.000	17.685	0	411

In the presented example, in the last two years of analysis, the bonus rose from 6,000 lei to 17,685 lei as a consequence of having exceeded the target for the average economic profit at the value of 1 leu of invested capital.

The limits that are applied to this method of incentive granting for management are generated by the value management’s application at company level. Thus, significant results, both in performance measurement and created value, and the incentive granting for management can be obtained by using EVA as a basic indicator. By using EVA, the average economic profit at the value of 1 leu of invested capital can be calculated along with the method of incentive granting presented above.

**Conclusions**

The necessity of correlating the shareholders’ specific targets with those of the management is obvious. In our opinion, the limitation of the negative effects of the moral hazard can be achieved by a consistent implementation of a set of rules for incentive granting with the value creation indicators playing a central role. Even if during high volatility periods

financial markets behave inefficiently, on a long term basis the assessment of management performance closely related to the created value is considered the strategic method to be adopted in order to assure that the investors' interests are met.

As the use of a single indicator in assessing performance implies some objective limitations, we intend to further develop and validate a reliable indicators system for the correlation of real performance generated by management action with both the size and the form under which incentives granted to the company management are granted.

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