Innovation in Action Series
May 2009

How to break free from the short-term performance trap

Author: Jeremy Hope

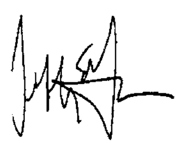
Information Management

Cognos. software

There's one in almost every company: You know – the executive who wants to set short-term targets, create incentives, and "manage" earnings, all under the guise of driving shareholder value. Then the targets – totally unrealistic – cascade down through the organization and all functions are expected to hit them. The sad reality is that such "performance contracts" constrain innovation, limit flexibility, inhibit visibility into likely future performance, and really make little sense at all.

In this paper, Jeremy Hope examines evidence about target setting, earnings guidance, and executive incentives, and explains why increasing numbers of companies are moving away from such practices and breaking free from the short-term performance trap.

"How to Break Free from the Short-term Performance Trap" is the third in a new series of papers written for the IBM Cognos® Innovation Center for Performance Management by Jeremy Hope, Research Director of the Beyond Budgeting Round Table. Jeremy is an advisor to the Innovation Center. He is also a tireless champion for innovation in performance management theory and practice, believing that business-as-usual is NOT a route to success.



Jeff Holker
Associate Vice President
IBM Cognos Innovation Center for Performance Management

The view of the organization as a machine—with levers that can be pulled to change efficiency, speed, and direction—has been held by leaders for hundreds of years. Its origins go back to Sir Isaac Newton's model of the physical world as a clock-like mechanism in which one gear turns and makes another gear turn, then another, and so on. This notion addresses one of man's deepest fears—that of losing control. In his 1959 book *Big Business and Free Men*, James Worthy explains that this obsession with control springs from a failure to recognize or appreciate the value of spontaneity, either in everyday work or in economic processes—hence the need for planning, with the machine as model for human organization. For the machine has no will of its own. Its parts have no urge to independent action. Thinking, direction—even purpose—must be provided from outside or above.

Direction and purpose were provided through a "performance contract" between superiors and subordinates. The classic performance contract has its roots in F. W. Taylor's principles of scientific management, which he described in the following way: "Each employee should receive every day clear-cut, definite instructions as to just what he is to do and how he is to do it, and these instructions should be exactly carried out, whether they are right or wrong." Clearly, Taylor saw people as machines to be programmed and controlled. And in 1911, such a view was neither uncommon, nor was it seen as overly oppressive. However—programming and controlling the output of individual production workers was one step, but applying the same principles to whole companies and parts of companies, was another step altogether. It could only be done with the use of accounting numbers to set targets and control performance. It elevated the finance function to the center of organizational power until, within a few decades, its role as scorekeeper had been eclipsed by its role as performance controller. In effect, finance became the guardian of the budget, defender of the group profit forecast, and enforcer of the performance contract. How did this happen? And what is the role of performance contracts today?

It started in the 1920s with the development of the budget as a tool for managing costs and cash flows in such large industrial organizations as DuPont, General Motors, ICI, and Siemens. In these multidivisional organizations, managers first decided which products to make, then how many to produce, and then how much marketing muscle was required to persuade customers to buy them. Budgets were tailor-made for the job. They provided managers with the information they needed to plan, make, schedule, and sell a range of products and services to compliant customers.

These organizations were built and run by engineers, technicians, and marketers whose first concern was the efficiency of work processes and the building of brands. It wasn't until the 1950s that budgets evolved into performance contracts. By the early 1970s, accounting results dominated most managers' attention to the point where they no longer knew— or even cared—about the production, technological, and marketing determinants of competitiveness.

In the 1980s and 90s leaders became increasingly obsessed with creating shareholder value. Indeed, many believed that they could achieve this by managing financial variables alone. They began to see the company as no more than a portfolio of assets whose worth hinged on balancing risks and return, not on creating value for the customer. "Chainsaw" Al Dunlap became a crusader for shareholder value as he closed down factories and cut product lines. Businesses didn't need to grow or satisfy customers, they only needed to "unlock under-performing assets." But his status soon turned from hero to villain as it dawned on shareholders that his actions ended up destroying value as employees and customers voted with their feet and order books respectively. Nevertheless, many companies began to use shareholder value targets as a basis for their performance contracts.

Figure 1 shows the typical performance contract pyramid that can be seen in most organizations today. It begins with an "earnings" performance contract with external parties (such as investors or bankers), and then cascades down the organization in the form of "budget" contracts between executive leaders and operating managers.

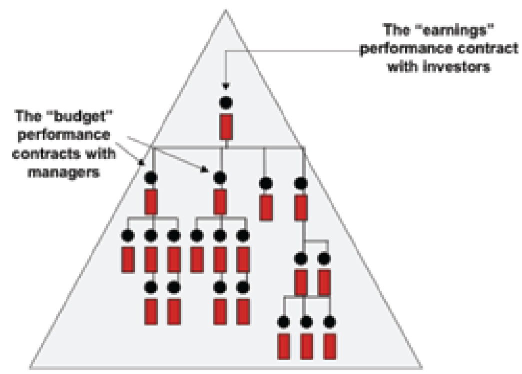


Figure 1

An *earnings contract* with investors (or bankers) is an implicit commitment by executive leaders to achieve an agreed-upon level of performance for the next quarter or year. This is how it works: Expectations of future performance are already factored into the share price, so the only way the price changes is if new information suggests that current expectations need to be revised upwards or downwards. New information reaches the market in different ways. Sometimes it is provided through approved press releases concerning products, technologies, patents, strategies, acquisitions, and alliances. But the most important information concerns earnings forecasts for the period ahead. Sometimes this is a public statement by the CEO, or it can reach the investment community through a series of "nods and winks" from business leaders to analysts. Once the forecast has been set, however, it becomes a contract to deliver results. Little happens if expectations are met, but if they fall short, then a heavy price is paid in terms of a (usually sharply) lower share price. The implicit "performance contract" with the market has been broken and leaders lose credibility, bonuses, and even, in some cases, their jobs. The external performance contract sets the reference level for all *internal budget contracts*.

The purpose of the budget contract is to delegate the accountability for achieving agreed outcomes to divisional, functional, and departmental managers.

Many CEOs feel trapped by the performance contract. When interviewed for a Fortune Magazine article, Daniel Vasella, CEO of Novartis, said that "the practice by which CEOs offer guidance about their expected quarterly earnings performance… has become so enshrined in the culture of Wall Street that the men and women running public companies often think of little else. They become preoccupied with short-term 'success,' a mindset that can hamper or even destroy long-term performance for shareholders."

Breaking free from the short-term performance trap depends on two principal actions: **(1)** ceasing the practice of giving fixed earnings promises and then "managing" earnings and **(2)** neutralizing the impact of executive incentives.

Cease the practice of providing earnings guidance

There are a number of reasons why earnings guidance no longer represents "good" practice (if it ever did).

- *It focuses managers' attention on short-term results.* While corporate leaders are supposed to base key decisions on net present value calculations (usually based on long-term forecasts), only 59 percent of financial executives say they would pursue a *positive* net present value if it meant missing quarterly earnings targets.[1] "Managing the quarter" is an obsession with many CEOs continuously under the spotlight of the investment community. They constantly tamper with the business by raising or cutting discretionary expenditure such as R&D, marketing, and improvement initiatives to meet investors' expectations. What this does for longer-term wealth creation is anyone's guess.

- *It encourages organizations to set aggressive targets and incentives and then manage the numbers rather than the business.* While Enron is the highest profile case of managing earnings, there are many other examples. During the 1990s Gillette engaged in "trade loading" or stuffing its distribution channels with goods at the end of quarters to push up sales.[2] Coca Cola used capital gains from selling bottlers to smooth its earnings.[3] And Citicorp ignored special charges when presenting its growth figures.[4] Large European companies such as Ahold and Parmalat have been no less culpable.

- *"Managing" earnings sends all the wrong messages to the rest of the business.* It says that it is acceptable to manipulate, fudge, and spin the numbers to make performance look better than it really is. This goes against the grain of good corporate governance. The result has been a loss of faith in corporate governance and in the reputations of business leaders.

- *Leaders set themselves up for a fall.* Leaders can quickly turn from heroes into villains by missing earnings targets or being forced to make up the numbers to retain credibility. That was of course what happened in all the major corporate governance cases that we've seen over the past five years.

- *The legal consequences (with compliance rules such as Sarbanes-Oxley) are that leaders are more exposed if they get forecasts badly wrong.* With both CEOs and CFOs having to sign-off on quarterly and annual statements as to their accuracy, missing earnings targets takes some explaining.

In a 2006 report, McKinsey & Co asked executives why they issued guidance and the answers were uniform: "higher valuations, lower share price volatility and improvements in liquidity." But their review of around 4,000 companies failed to support these perceptions. In fact, they found no evidence that issuing frequent earnings guidance affects valuation multiples, improves shareholder returns, or reduces share price volatility. The only impact was the increase in trading volumes that only affects companies with illiquid shares. On the contrary, the evidence suggests that providing quarterly guidance has real costs including the time that senior management must spend preparing the reports and an excessive focus on short-term results. McKinsey concluded that in the light of this evidence, the only reason why companies continue the practice is to maintain good communications with analysts and investors. *They recommend that companies that don't currently issue guidance should avoid the temptation to start providing it and instead, focus on disclosures about business fundamentals and long-range goals*.[5]

Increasing numbers of companies are saying "no" to guidance. The percentage of US companies that give guidance has fallen from around 75 percent to 55 percent in recent years. In an SEC filing, Barry Diller, CEO of USA Networks, said he would no longer participate in a process he likened to a kabuki dance. Warren Buffett is a devout believer in not giving earnings guidance. That's why such companies as Coca-Cola and The Washington Post Co. have stopped the practice. When Coca Cola ceased giving earnings guidance, its CEO Douglas Daft said in a statement: "Our share owners are best served by this because we should not run our business based on short-term 'expectations.' We are managing this business for the long-term."[6] Citigroup and Motorola have also ceased giving guidance. Intel stated that, "updates were increasingly irrelevant to managing the company's long-term growth."[7]

Many executives will worry about the reactions of analysts. If they don't provide guidance, how would analysts react? In the end, the market will decide if less information is preferable to more. Doom-sayers will point to companies such as AT&T whose shares plummeted 20 percent the day it announced that guidance would no longer be provided. However, the context is important. After all, AT&T

also announced disappointing financial results at the same time. But when McKinsey analyzed 126 companies that discontinued guidance, they found that that they were as likely to see higher as lower total shareholder returns compared with the market. The short answer is that leaders can overcome the fear of analysts by building trust and delivering consistent results. Most leaders know that, while performance promises might give the share price a short-term boost, their forecasts rely on a few key assumptions that are, by and large, beyond their control. Not giving guidance, however, does not mean withholding information. Some companies invite analysts to gain a deeper understanding of the business and are prepared to share a wealth of information with them, but not give them specific targets.

The McKinsey report concluded that the current trend – more and more companies discontinuing quarterly guidance and substituting thoughtful disclosures about their long-range strategy and business fundamentals – is a healthy one.[8] The cessation of earnings guidance is important in another sense. It reduces the temptation to set a plethora of internal targets that, when aggregated, meet the group target. This gives leaders the opportunity to cease the target-setting practice at every level of the firm, thus going a long way toward eliminating the root causes of bad behavior and improving corporate governance.

Neutralize the impact of executive incentives

Executive compensation is another key component of the short-term performance trap. Many boards tie executive pay to performance. This usually takes the form of financial bonuses, share options, and restricted shares (that can only be sold within agreed parameters). Share options can double average compensation packages. Another problem is the short-term tenure of most CEOs (between three and four years). Few are willing to take bets on longer-term investments. The risk that any new venture will fail is quite high (say, six or seven chances out of ten).

Many boards assume a correlation between executive incentives and financial results. But the correlation is tenuous at best, and downright misleading at worst. A UK study of the top 350 firms concluded there was no evidence that executives' long-term incentive plans had a positive impact on total shareholder returns, but that incentives did have a significant financial cost to shareholders.[9] Another research study undertaken by McKinsey & Co suggests that there is an inverse correlation between top executives' pay and innovation. They note that the secret of persuading people to focus simultaneously on developing new businesses and managing current operations may be to rely less on pay for performance.[10] Another recent study in the American baseball leagues suggests that the greater the difference between the pay of the stars and that of the rest of the team, the less impressive is the performance of the stars and the team as a whole.[11]

So what can boards do to keep their reward schemes, yet reduce the most toxic side effects that drive the wrong behavior? Some organizations use a few approaches such as using "bonus banks" that pay rewards based on performance over a number of years, tying performance, not to fixed targets, but to results compared with peers, and forcing executives to hold stock for a number of years.

- *Use "bonus banks" to reduce risk.* To avoid executives taking short-term actions to maximize their bonuses, some companies are using "bonus banks" to spread payments out over a period of time. Essentially, each executive's bonus is "banked" and paid out over a number of years; that is, only a third or a half of the bonus bank can be paid out in any year. Clearly, a company cannot pay a bonus one year and take it back the next. The bonus bank ensures that performance is sustained or the payment made is significantly reduced. Companies such as Diageo and Eli Lilley operate with this type of plan.

- *Base rewards on relative performance.* Alfred Rappaport, one of the founding fathers of value-based management, believes that fixed-priced options reward executives for any increase in the share price—even if the increase is well below that realized by competitors or by the market as a whole. He believes in the power of shareholder value measures to evaluate and reward executive performance, provided that such measures are based on returns equal to or better than those earned by the company's peer group or by broader market indexes.[12]

- *Compel directors to hold their stock for the long-term.* Some boards are insisting that directors hold their stocks for longer than the usual three-year period. At Exxon Mobil, top executives can't sell half of their restricted stock grants for five years, and must hold the other half for ten years or until retirement. In another positive trend, many companies now insist that their executives hold between five and eight times their annual salary in shares. At J.P. Morgan Chase, CEO Jamie Dimon is making senior executives retain 75 percent of stock awards until they leave the company.[13] Extending the length of time that executives hold stock negates many of the toxic effects of short-term actions designed to impact the short-term share price but damage future wealth creation.

Today's leaders face the overwhelming task of restoring confidence and respect in both leadership and in business, while guiding their organizations through times of turbulence and uncertainty. This calls for a different type of leadership, one that is less about being a high-profile public figure and more about being focused on operating performance and business fundamentals. Making that change successfully largely depends on ceasing the practice of giving earnings guidance and compensating boards (and especially the CEO) fairly, but not excessively.

About the IBM Cognos Innovation Center for Performance Management

The IBM Cognos Innovation Center is dedicated to transforming routine performance management practices into "next practices" that help cut costs, minimize risk, streamline processes, boost productivity, enable rapid response to opportunity, and increase management visibility. Staffed globally by experts in planning, technology, and performance and strategy management, the Innovation Center partners with more than 600 IBM Cognos customers, academics, industry leaders, and others seeking to accelerate adoption, reduce risk, and maximize the impact of technology-enabled performance management practices..

About IBM Cognos BI and Performance Management

IBM Cognos business intelligence (BI) and performance management solutions deliver world-leading enterprise planning, consolidation and BI software, support and services to help companies plan, understand and manage financial and operational performance. IBM Cognos solutions bring together technology, analytical applications, best practices, and a broad network of partners to give customers an open, adaptive and complete performance solution. Over 23,000 customers in more than 135 countries around the world choose IBM Cognos solutions. For further information or to reach a representative: www.ibm.com/cognos

Request a call

To request a call or to ask a question, go to www.ibm.com/cognos/contactus. An IBM Cognos representative will respond to your enquiry within two business days.

IBM Canada
3755 Riverside Drive
Ottawa, ON, Canada K1G 4K9

Endnotes

1 Judith Samuelson *A Critical Mass for the Long Term* Harvard Business Review February 2006, 62-63.

2 Carol J. Loomis *The 15% delusion* Fortune Magazine February 5, 2001, p52

3 Carol J. Loomis *The 15% delusion* Fortune Magazine February 5, 2001, p53

4 Carol J. Loomis *The 15% delusion* Fortune Magazine February 5, 2001, p52

5 Peggy Hsieh, Timothy Koller and S.R. Rajan *The misguided practice of earnings guidance* McKinsey on Finance Number 19, Spring 2006

6 www.knowledg.wharton.upenn.edu

7 Peggy Hsieh, Timothy Koller and S.R. Rajan *The misguided practice of earnings guidance* McKinsey on Finance Number 19, Spring 2006

8 Peggy Hsieh, Timothy Koller and S.R. Rajan *The misguided practice of earnings guidance* McKinsey on Finance Number 19, Spring 2006

9 Francesco Guerrera *Executive shares fail to raise value* Financial Times May 14, 2001, 1

10 Jonathan D. Day, Paul Y. Mang, Ansgar Richter and John Roberts *Has pay for performance had its day?* Mckinsey Quarterly 2002, Number 4

11 John W. Hunt *Reward systems and disincentives* Financial Times April 21, 1999, p21

12 Alfred Rappaport *How To Link Executive Pay With Performance* Harvard Business Review, March-April, 1999, p93

13 Shawn Tully *Five Commandments for Paying the Boss* Fortune Magazine July 10, 2006, 51-53

IBM Cognos
Innovation Center
for Performance Management

IML14153CAEN