



Current topic: Sustainable Compensation Systems for Executives

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June 2011

1. Legal Background on Sustainability in Executive Compensation

The worldwide financial crisis during the years 2008 and 2009 revealed serious shortcomings in corporate governance and executive compensation. The lack of sustainability in executive compensation has been blamed for being an important reason for the crisis. During the following debate, the German Government launched the Act on the Appropriateness of Management Board Compensation (VorstAG). Moreover, the government commission of the German Corporate Governance Code (GCGC) included amendments to the code to make executive compensation more sustainable.

According to the GCGC, the main purpose of the board is “to ensure the continued existence of the enterprise and its sustainable creation of value“ (GCGC (2010), p. 1). Therefore, the government commission included a recommendation on the structure of executive pay. According to the GCGC, this structure “must be oriented toward sustainable growth of the enterprise” (GCGC (2010), p. 7). Similarly, the German Public Companies Act (Aktiengesetz) requires an executive pay structure that is aligned with a sustainable development of the company (§ 87 para. 1 clause 2 AktG).

However, the GCGC provides no definition of sustainability. Some authors define sustainability in the context of corporate governance as long-term value creation, assuming that this target can only be achieved with the continuous effort of all stakeholders (see Werder (2011), p. 55). This short paper discusses different compensation elements and their suitability for creating sustainable incentives. We also provide an explorative overview, how large German companies adjusted their executive compensation structure recently.

2. Sustainability and the design of executive compensation systems

Executive compensation includes several components. Besides base salary, there is variable cash compensation (bonus), share based compensation, pension benefits and one-time payments like severance or welcome payments. We focus on variable cash compensation and share based compensation, since they provide incentives to management. If sustainability is defined as creating long-term value, executive incentive compensation must reflect this objective. Hence, executive compensation on the one hand needs to be long-term oriented and, on the other hand, must use performance measures that are aligned with the objective of sustainability.

2.1. Long-term compensation

2.1.1. Share based compensation

Share based compensation provides long-term incentives since the share price reflects the long-term business prospects of a company. This is true, if the capital market is able to correctly estimate future developments of a company. Offering shares and options to executives encourages them to focus attention on share price as a metric for increasing overall corporate value. As the share price is a result of market expectations, it is difficult for management to manipulate it. However, corporate management may have better information than the market. In this case, management can to a certain extent influence stock price by its disclosure policy. If management can sell company's stock from its stock-based compensation without restrictions, the intended long-term incentives would be lost.

The German Government addressed this issue by introducing a blocking period of at least four years for the first-time exercise of stock options in § 193 para. 2 No. 4 AktG, which relates to newly authorized capital. It does not, however, affect existing stock option programs (§ 23 para. 3 EGAktG). According to § 71 para. 1 No. 8 clause 5 AktG, the rule applies mutatis mutandis in the case of acquiring own

shares. Although the blocking period in § 193 para. 2 No. 4 AktG is only mandatory for real stock options, the same blocking period also applies for shares and any virtual stock option plans like phantom stocks or stock appreciation rights (BT-Drs 16/12278, p. 5).

Within the German stock index DAX 30, most companies use share based compensation elements. In 2010, only six out of thirty companies report that they do not provide any share based incentives, e.g. Volkswagen and Adidas. In line with the new German law, more than half of the companies with stock-based compensation require a blocking period of four years or higher. However, there are still several companies with blocking periods of two or three years due to existing contracts. Some companies require their executives to hold certain amounts of stock during their entire tenure. At Siemens, for example, the CEO is required to hold shares worth 300% of his average base salary for the duration of his tenure.

2.1.2. Variable cash compensation on a multi-year assessment

Variable cash compensation can be based on annual or on multi-year performance measures. They are long-term, if they are based on multi-year performance measures. The new German law requires public companies to base variable cash compensation on the performance of several years (§ 87 para. 1 clause 3 AktG; GCGC (2010), p. 7). Only if the overall incentives are long-term, a small fraction of bonuses based on annual figures is permitted (BT-Drs 16/13433, p. 10).

There are several reasons for basing compensation on the performance of several years instead of only one year. First, due to existing accounting rules, management has some choices when calculating profit figures. Basing compensation on the performance of several years limits the management's incentives to manage earnings. Second, annual profit can be increased by activities that reduce future profits. For example, reducing research expenses immediately increases current profits but may lead to poor performance in future years. Third, since the upside of bonuses is unlimited while the downside is limited to zero, management has high risk-taking incentives when bonuses are based on short-term performance.

There are two ways to calculate long-term cash compensation. First, the bonus can be calculated using an average performance over several former years. Second, the bonus is paid after a defined period of several years based on a multi-year performance. This deferred payout creates sustainable incentives, because the bonus level depends on a future performance over several years (see Friedl/Döscher (2009), p. 36/37).

In 2009, 92% of variable cash compensation of the DAX was short-term oriented. Only five companies paid their executives a bonus on a multi-year assessment (see Friedl et al. (2010), p. 33/34). In 2010, the compensation structure has entirely changed due to the new rules. Now 50% of the DAX companies calculate bonuses or at least part of their bonuses on a three-year assessment. Few companies even use longer periods. For example, K+S uses an eight-year horizon in the long-term incentive plan. Variable compensation is calculated based on two four-year periods (a “reference period” and a “performance period”). The performance period considers the development in future years and the manager receives the bonus payment after the four-year period. For calculating the level of the bonus not only the performance period is relevant but also the reference period which refers to past performance.

2.1.3. Bonus bank systems

Within a bonus bank system only part of the annual bonus is paid directly while the rest of the bonus is transferred to a bonus bank account and paid in the following years according to a defined payment rule. Similar to a multi-year bonus, the manager not only participates from profits but also from losses which can be netted against profits of other years. So the bonus bank fulfills the requirement of the GCGC which recommends taking positive and negative developments into account when determining compensation (GCGC (2010), p. 7).

In 2010, only few DAX companies implemented a bonus bank system, e.g. Daimler and Deutsche Post. At Daimler, 50% of the annual bonus is paid out directly while

the rest is paid out one year later depending on the development of Daimler's share price compared with an automotive index.

2.2. Sustainable performance measures

In order to make executive compensation more sustainable, the choice of performance measures is crucial. While in executive compensation financial performance measures are prevalent, non-financial measures have attracted more attention recently. They are considered to be leading indicators of future performance.

2.2.1. Financial performance measures

Traditionally, financial performance indicators play an important role in executive compensation. While stock-based measures include information about the future, accounting-based measures provide only information about the past development. Therefore, stock-based measures better inform about sustainability. One third of the DAX companies link their bonuses on indicators like Total Shareholder Return, e.g. Deutsche Börse and Münchener Rück.

Accounting-based measures can be based on many different accounting figures. Revenues, for example, do usually not include information about sustainability. Aggressive growth strategies would boost revenues without informing about the sustainability of these revenues. Few DAX companies like Siemens and SAP rely on revenue figures as a basis of assessment.

Profit, cash flow and profitability ratios are more sustainable as they consider not only the output, but also the input. All DAX companies include these kinds of figures. While Henkel, Metro and ThyssenKrupp use rate-of-return measures like RoCE, Deutsche Telekom and Siemens provide incentives on the basis of Free Cash Flow. EBIT and similar profit figures are used by 60% of the companies, e.g. Linde, Daimler and E.ON. However, since EBIT does not include the cost of capital,

positive EBIT figures do not indicate sustainable activities. Even if EBIT is positive, value may be destroyed.

Among the accounting figures, value-based performance metrics like Economic Value Added are the most sustainable ones (see Friedl/Deuschinger (2008)). They include the cost of capital and, when used over many years, are able to show whether value has been created or not. Seven companies including Deutsche Post and K+S calculate part of the bonus on EVA or a similar measure, which considers the cost of capital. Commerzbank plans to do so in 2012.

2.2.2. Non-financial performance measures

Non-financial performance measures have gained a lot of popularity due to their alleged ability to predict future performance. For example, employee and customer satisfaction can inform about the future performance of a company. Supporters also argue that non-financial performance measures are able to inform about the performance with respect to stakeholders other than the shareowners.

Opponents counter that there is no clear link between social commitment and financial performance. It is not clear at all, whether an increase in employee satisfaction is associated with more sustainability. There are concerns that non-financial indicators can be quite easily manipulated. For example, employee satisfaction can be heavily affected by recent positive events like an increase in salaries.

For the DAX companies, non-financial figures become increasingly important as a basis for variable cash compensation. Nine companies including Volkswagen, SAP and Deutsche Telekom involved employee and customer satisfaction or other non-financial indicators in their executive compensation systems. 50% of the companies reported “individual goals” or “individual performance” to be relevant for bonus calculations. This development shows that companies frequently consider non-financial ratios to be informative about sustainability.

3. Summary

Aligning executive compensation with sustainable value creation is an important current topic for German companies. Recent legal activities are a driver for this development. Although the exact definition of sustainability is not clear, the changes in the structure of top executive compensation in the DAX 30 companies show, how they interpret sustainability.

On the one hand, the long-term component becomes more important. Blocking periods for stock-based compensation are extended. The usage of multi-year performance measures and bonus banks increases. On the other hand, more companies include non-financial and subjective performance indicators in compensation contracts. In particular, performance measures related to employee and customer satisfaction become increasingly popular.

Whether these developments support sustainable value creation is not clear. It will be interesting to see, how top executive decisions will be influenced by the changes in the incentive system.

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