How to link value creation to executive compensation

The recent financial scandals, with stories of fat bonuses received by senior executives just the year before the Stock Exchanges collapse have once again increased the interest on the topic of executive compensation.

The concern about this topic is unanimous and ubiquitous: shareholders meetings, media coverage, political debates, regulators, auditors, etc.

While modern economic and managerial theory underlines the importance of aligning executives' interests with their company long term value creation, most of today's executives incentive schemes have actually fail to deliver the "reward for value creation" principle.

We believe that compensation systems must not be considered as "stand-alone" standard packages of metrics and technicalities provided by HR Consultancies, but as a key component of an overall value-oriented company management framework.

To ensure the "reward for value creation" principle, companies need to align their strategic goals to value creation indicators, set proper targets, identify plan and actions to achieve value targets, monitor and finally reward the value creation.

Our consulting experience in corporations listed on the stock exchange, with transparency requirements of disclosure on governance and compensation systems, has enabled us to develop effective frameworks to ensure alignment between managers' reward and business performances, avoiding those distortions and pitfalls that public opinion and BoDs are now blaming.

Below we present some key features an effective compensation system linked to sustainable value-creation must have:

- Link reward to indicators that measure sustainable value creation in the long-run
    - Set quantitative, measurable metrics, reducing, where possible, the use of short-term and risk-insensitive accounting-based indicators (like EPS) in favor of value-driven metrics like EVA, EP, etc.
- Set a proper mix of short/long-term targets, including multiyear performance targets
- Introduce longer vesting periods and rolling emission for stock options or, eventually, stock ownership mechanisms
- Measure direct performance against industry competitors and peers
    - Take away exogenous factor or scenario effects (e.g. general market trends/tides)
- Introduce bonus banks mechanism
- Breakdown, differentiate and deploy the compensation system within Corporate and BUs
    - Customize metrics and compensation packages design through the organization, on the basis of management level, specific KPI goals, role, impact and available levers
    - Consider the geographical dimension (multi-country corporations)
- Make management compensation mechanisms clear, disclosed and public.

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