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**PERFORMANCE MEASUREMENT AND
INCENTIVES IN LOSS-MAKING ENTITIES:
A FIELD STUDY**

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Performance Measurement and Incentives in Loss-Making Entities: A Field Study

Abstract: Prior research has shown the absence of a significant link between financial performance measures and cash incentive payments in loss-making firms, but only conjectures have been offered to explain this finding. To understand both the causes of this finding and the practices that loss-making entities use instead of linking incentive payments to financial measures, we conducted a field study of 13 loss-making entities, both public and private, across three types of loss-making situations (pre-profit, transitory loss, and financial distress) and two organizational levels (firm and divisional). We find, surprisingly, that a majority of these loss-making entities do link financial measures to incentive payments. At the same time, however, they also focus on other measures, both specific financial line-items higher in the income statement (e.g., revenue) and nonfinancial measures; they enforce unachievable minimum-threshold performance levels; and/or they evaluate performance subjectively. The reasons for weakening the financial performance/reward link vary systematically across settings.

INTRODUCTION

The incidence of losses in corporate entities has increased remarkably over the last 25 years (Skinner 2004). In 1980, 20% of the firms listed in the Compustat database reported negative income before extraordinary items. By 1990, the proportion had increased to about 40%. In 2000 it was 54%, and during the recession in 2001, the proportion of loss-making firms was 59%. In addition, even profitable firms typically contain some loss-making entities (e.g., subsidiaries, divisions). These figures suggest that investigations specifically focused on loss-making entities are warranted.

Investigations of incentive compensation practices in loss-making entities might be particularly interesting. Many incentive compensation systems have evolved from a philosophy of sharing profits (Garvey 2005), but that philosophy might not be applicable in loss situations. Moreover, prior research suggests that loss-making and profitable firms differ in how they provide incentives. For example, although executive cash compensation and accounting earnings are significantly positively related in general (Sloan 1993; Lambert and Larcker 1987), there appears to

be no such link when earnings are negative (Adut et al. 2003; Gaver and Gaver 1998). And, Gibbs et al. (2004) found that when losses are incurred, annual bonuses are much more likely to be assigned subjectively, rather than based on profit-linked formulas that predominate in profitable entities.

The reasons underlying these differences in practice are not well understood, however. The purpose of our field study, therefore, is to examine how incentive systems are designed in loss situations and, importantly, why the various incentive design choices are made. We explore these how and why questions in three types of loss-making situations (pre-profit, transitory loss, and financial distress), in both public and private entities, and at two levels of analysis (firm and division).

We find that a majority of the loss-making entities do design their incentive contracts with links between financial performance measures and incentive payments. But we also find that the loss-making entities take any of several actions that weaken the link between financial measures and cash incentive payments. They focus on other measures, both specific financial line-items higher in the income statement (e.g., revenues) and nonfinancial measures; they enforce unachievable minimum-threshold performance levels; and/or they evaluate performance subjectively. We find that loss-making entities have multiple reasons for weakening the financial performance/reward links, including a lack of informativeness of the financial measures and/or the standards used to evaluate performance; desires to limit managerial risk; and/or desires to avoid political costs. Some of these reasons are consistent with conjectures proffered in prior studies (e.g., Gaver and Gaver 1998), but some are new. Moreover, we find that these reasons vary systematically across settings, with the type of loss situation being faced (pre-profit, transitory loss,

financial distress), the entity's ownership structure (public/private), and the organizational level (firm, division).

In the next section, we review the relevant literature. Section 3 explains the method. Section 4 presents the findings. The final section summarizes and concludes.

LITERATURE

Although no published studies have focused explicitly on incentive system design in loss-making entities, several studies have suggested that incentives provided in loss-making entities seem to be different from those provided in profitable entities. Gaver and Gaver (1998) and Adut et al. (2003) found that cash compensation is significantly and positively related to earnings only if earnings are positive. Gaver and Gaver (1998) conjectured several reasons for the absence of linkage between earnings and cash bonuses, which we group as factors related to: (1) the informativeness of earnings in loss conditions; (2) the need to limit the downside compensation risk that managers bear; (3) the need to offer competitive compensation packages for managerial attraction and retention purposes; and/or (4) managerial entrenchment.

First, the informativeness argument (Lambert 2001; Datar et al. 2001; Feltham and Xie 1994; Banker and Datar 1989; Holmstrom 1979) implies that in loss conditions, earnings might not be effective at conveying information about the desirability of the managers' actions. One variation of the poor informativeness argument occurs where the short-term losses are just an artifact of conservative accounting rules requiring the immediate or rapid expensing of business-building investments. This occurs where the managers of the loss-making entities are making good investments, those that are creating long-term value, but are forced to report losses due only to the fact that accounting rules require an immediate or rapid expensing of the investments (Engel et al. 2003; Ittner et al. 2003; Lev 2001).

The expected implication of poor informativeness of bottom-line financial measures¹ is that the weight placed on them for incentive purposes should be reduced, or at the extreme, that such measures should not be used for incentive compensation purposes. If financial performance measures are not informative about the desirability of the actions managers are taking, evaluators might focus instead on nonfinancial performance measures (Banker et al. 2000; Ittner and Larcker 1998; Ittner et al. 1997). Or they might evaluate performance subjectively, and in so doing focus on any of a broad range of performance indicators (Gibbs et al. 2004; Baiman and Rajan 1995; Baker et al. 1994).

Second, the risk-limiting argument stems from the reality that the vast majority of managers are risk-averse. Bottom-line financial measures of performance (earnings) are affected by many factors that the managers cannot control, and it might not be optimal to have the managers bear (all of) this risk (Baker and Jorgensen 2002; Baker 1992). If they bear uncontrollable risk, managers are prone to demand higher expected compensation and/or to take harmful actions (e.g., avoiding certain types of investments, negotiating for budgetary slack) to protect themselves from the downside risk (Van der Stede 2000). Merchant (1989) found that most evaluators were quite willing to protect managers from downside risk (i.e., unforeseen bad luck), even though they rewarded the managers when they were the beneficiaries of unforeseen good luck.

The risk-limiting argument has several possible implications. Managerial risk can be limited by basing bonuses not on formulas based on measures defined in financial performance terms but instead on formulas defined in terms of specific measures over which the managers have greater control, such as nonfinancial measures or specific financial line-items higher in the income

¹ Unless we discuss the findings of specific studies that were focused on “earnings,” we generically use the term “bottom-line financial performance measures” to include measures of accounting profits (earnings or net income), return measures (where accounting profits are in the numerator), or residual income measures (where accounting profits are reduced by some capital charge).

statement (e.g., revenues) (Ittner et al. 1997), and/or by making subjective assessments of performance (Gibbs et al. 2004; Murphy and Oyer 2003; Baiman and Rajan 1995; Baker et al. 1994). Both approaches reduce the linkage between earnings and cash compensation.² Making financial targets more achievable is another approach to reducing risk (Merchant and Manzoni 1989). In loss situations, however, this would likely involve setting earnings targets at negative levels.

Third, from a labor market perspective, firms must offer competitive contracts to attract and retain good managers. Managerial attraction/retention is a primary purpose of compensation contracts (Chen 2003; Brickley et al. 2002; Prendergast 1999; Baker 1992), and in loss situations, retention of key managerial talent is often particularly important, and challenging. If competitors are paying their managers bonuses, even in loss-making times firms might have to make bonus payments to retain their managers. The implications for incentive compensation of the labor market argument are similar to those for the risk-limiting argument: base bonuses on specific measures that are controllable and almost certainly will lead to some bonus payout; provide discretionary bonuses (i.e., evaluate performance subjectively); and/or make bottom-line financial measures more, or almost certainly, achievable.

Finally, managers may have superior bargaining power in compensation negotiations if their evaluators (e.g., compensation committee) perceive that no one can do the job as well as they can. This power allows them to negotiate favorable compensation terms, which might include bonus payments even when losses are being incurred. Supporting this argument, Cheng (2004)

² The link between earnings and cash bonuses is severed in this case only to the extent that the nonfinancial measures and specific financial line-items higher in the income statement are contemporaneously weakly correlated with earnings. This is one of the central concepts underlying the use of nonfinancial measures in the accounting literature (Banker et al. 2000; Ittner and Larcker 1998; Ittner et al. 1997). With regards to specific financial line-items higher in the income statement, the weak correlation with earnings could be due to poor matching of revenues and expenses, such as in high-growth firms (Ittner et al. 2003).

showed that managerial entrenchment reduces the sensitivity of cash compensation to earnings in loss-making firms. The implications for incentive compensation are again the same as those for the risk-limiting and labor-market arguments in that entrenched managers are likely to be able to negotiate incentive contracts that include measures that almost certainly will lead to bonus payouts (either easy-to-achieve financial measures or controllable nonfinancial measures) or discretionary bonuses (particularly if they feel they can “influence” subjective evaluations in their favor) (Prendergast and Topel 1993; Milgrom 1988).

Another possibility, not discussed by Gaver and Gaver (1998), is that incentive contracts are defined in financial performance terms, but the near-zero links between the financial measures and incentive payments are caused by failures to reach minimum performance thresholds (i.e., the earnings target) necessary for bonus payments (Murphy 2001). Firms might not adjust their earnings targets to reflect losses because of worries that negative earnings targets potentially compromise long-term motivation to avoid losses (Acharya et al. 2000). In other words, if the firm is able to credibly commit to not pay bonuses when there are losses, managers have strong incentives to try and prevent losses in the future (e.g., Potanger 2002). But the financial performance thresholds (earnings targets) might also be quite difficult to achieve in loss-making entities because these firms are often operating in uncertain, turbulent environments (Haveman 1992; Meyer 1982). Uncertain environments make target setting more difficult, and hence, target achievability is less predictable/assured (Merchant and Manzoni 1989; Merchant 1989, 1987).

These conjectures and observations suggest our first research question:

RQ 1: *In loss-making entities, are incentive contracts based on performance measured in bottom-line financial terms (earnings or earnings-based measures)?*

- a.*** *If so, what causes the weak/non-existent links between financial measures and incentives paid that have been observed in prior research? In particular, are the minimum performance thresholds (e.g., budgets) overly difficult to achieve in loss-making entities?*

- b. If not:*
 - i. Why not?*
 - ii. What do loss-making entities do instead, and why?*

One useful next step in theory-building in this area is to identify sub-groups of loss-making entities that do things differently. Loss-making entities can be classified in many different ways. Prior literature (e.g., Engel et al. 2003; Ittner et al. 2003; Gilson et al. 2000; Kim and Ritter 1999; Hayn 1995; Hotchkiss 1995; Gilson and Vetsuypens 1993; Jensen and Murphy 1990a, 1990b; Gilson 1989; Romanelli 1989) has distinguished three categories of loss-making situations.³ One includes relatively young entities operating in a pre-profit stage of development. A second includes entities that face transitory losses (i.e., those that are temporarily unprofitable but are in otherwise solvent businesses). A third category includes entities that are financially distressed (i.e., those that are in significant risk of failure).

This classification scheme might explain loss-making entities' incentive practices. When losses are transitory, concerns about providing ex ante incentives to avoid losses in the long-term might outweigh short-term managerial retention issues associated with not being able to pay bonuses in a given loss year. In financial-distress situations, on the other hand, where a major turnaround might be needed, both the need to reduce losses in the short-term (for survival), as well as retention issues of key managerial talent (for a successful turnaround), might be the most pressing concerns (D'Aveni 1989; Harrigan 1980).

Other entity factors might also have differential impacts on incentive contracts. For example, public firms can use stock-based incentives to substitute for incentives paid on the basis of performance measured in financial terms. It is more difficult for privately-owned firms to use this option because their stock is difficult for employees to value. In addition, as compared to private

³ Most of these prior studies, however, deal with issues related to the value relevance of losses rather than performance measurement or incentive issues.

firms, public firms are more likely to face “political costs” from paying bonuses while losses are being incurred (e.g., Lublin 2005; Masuda and Barends 2004; Fulmer and Kristof 2004). Investors (who are one source of political pressure) sometimes respond negatively to factors (in this case, providing incentives in loss-making periods) that actually may have a positive impact on a firm’s survival chances (e.g., because losses are being reduced) (Welbourne and Andrews 1996). Similarly, political pressure is more likely to have incentive contract impacts at the corporate level of analysis than at levels lower in the organization.

These observations suggest the following research question for exploration:

***RQ 2:** Do performance measurement and incentive practices in loss-making entities or the rationales for those practices vary systematically with differences between those entities?*

METHOD

To explore our research questions, we chose to conduct a field study because of the advantages this method provides (Baxter and Chua 2003; Ahrens and Dent 1998; Eisenhardt 1989). Field studies allow for the building of theory grounded in evidence (Strauss and Corbin 1990; Glaser and Strauss 1967). Rather than making inferences based on observable outputs of management processes as researchers relying on public information disclosures must do, field research allows for the examination of direct evidence about the phenomena of interest; here, performance measurement and incentive system choices. Field studies also allow for a more thorough examination of both “what” and “why” questions. They can provide a richer understanding of the system details, manager motivations and thought processes, and effects. As compared with archival research, field studies can also enable study of more types of loss-making entities, to include entities that do not disclose information publicly, including privately-held firms and business entities within publicly-owned firms.

We contacted managers who could inform us about performance measurement and incentive practices in a variety of loss-making entities. We sought to conduct our study in a diverse set of entities. In particular, we wanted to study entities in each of the three kinds of loss-making situations discussed above: pre-profit, transitory loss, and financial distress. We wanted to study both public and private loss-making firms and loss-making entities at both the firm and division level. And we did not want to focus our study on firms in just one or a few industries.

In total, we learned about the performance measurement and incentive practices in 10 loss-making firms, three of which were large enough that we could examine practices both at the corporate and division levels of analysis, plus three loss-making divisions in one profitable firm. The 11 firms (also counting the profitable one) were in varied industries, including financial services (3 entities), high technology (3), medical services (1), software (1), specialty retail (1), utilities (1), and consumer products (1). Within these firms, we interviewed executives in a variety of roles, including line managers, chief financial officers, and heads of compensation and benefits. The interviews varied significantly in length, from about one hour to multiple days. (We have followed some of these firms over a multi-year period.) The duration of the interviews varied with the complexity of the firm, the richness of the decision making process surrounding the measurement/compensation process, and the amount of time the managers were willing to spend with us.

During the interviews, we asked the managers to discuss their firm's performance measurement and incentive systems and the reasons why they were designed and used as they were. Given the exploratory nature of this field study, these discussions were nearly totally open-ended. Because we did not adhere to a strict, close-ended interview protocol, we could alter and expand our lines of questioning as we conducted our interviews and expanded our understanding.

Thus we do not have a complete set of data that can be used to compare and contrast all the research sites. This is typical, and even desirable, in an exploratory theory-building type of field study (Yin 2002; Van Maanen 1998). Later in the process, when a couple of interviewees asked for more information about the purpose of our study and the types of questions we would be asking, we sent them the brief description shown in Appendix A.

— Insert Appendix A —

As we progressed through our field-study work, in many instances we began to hear similar explanations of the observed performance measurement and incentive practices. Therefore, we believe that we have some generalizable findings allowing us to describe a relatively parsimonious set of factors that explains much of the variance in performance measurement and incentive practices, and the rationales for them, in loss-making entities.

FINDINGS

We organize our discussion of findings around the answers to the research questions.

Research Question 1

RQ1a asked whether loss-making entities base managerial incentives on bottom-line financial performance measures, and if so, what then causes the weak links between financial performance measures and cash incentives observed in prior work. Our finding related to this question was surprising. A majority (7 out of 10) of the loss-making firms we studied, and also one of the divisions of the profitable firm, do link bottom-line financial measures with cash incentives.

However, determining exactly what weight of importance is placed on bottom-line financial measures in these firms is difficult because of complexity and ambiguity in many of the contracts. Even when the weights are explicitly defined in the bonus contracts, the weights do not tell the entire story because bonus contracts typically include some contingencies, or they allow

subjective overrides. For example, when two of the seven firms that link financial measures with incentives had a bad year and reported significant, unexpected losses at the corporate level, no bonuses were paid to any executive-level personnel in these firms. Thus, in these two examples, the weight placed on the financial measures in the poor performance years was effectively 100%, even though the bonus contracts specified 33% and 75% weights on financial performance.

To assess the importance of the bottom-line financial measures in the entities that allow considerable subjectivity in the granting of incentives, we had to listen carefully to stories about how bonuses were assigned. For example, here is how a VP of Human Resources in one firm described the thought process of the firm's compensation committee as they considered the size of the bonuses to give the top management team in a recent year:

Let's see ... they met the revenue target; ... they didn't earn as much profit as we'd expected; ... but, they didn't have any major operational problems internally or externally, ... and they signed a big deal ... so, taken together, that probably warrants a bonus equal to potential for the year ...

In the entities where bonuses are assigned subjectively, we judged that the importance placed on the bottom-line financial performance measures in the assignment of incentive awards varied widely, from significantly less than 50% to 100%. But where the importance was high, the effect of poor financial performance (losses) on bonuses was invariably negative. Thus, subjectivity is not always just used to override reduced, or zero, formula bonus payments caused by losses, as suggested in prior work (Gibbs et al. 2004). On the contrary, in the entities where management ascribes to a "no-profit, no-bonus" philosophy or, perhaps more accurately, a "no profit, not much bonus" philosophy, subjectivity can lead to reduced bonus payments just like formula bonuses can.

Given the evidence from Adut et al. (2003) and Gaver and Gaver (1998), we were surprised that financial measure/incentive links existed in such a large proportion of the firms we studied.

We therefore tentatively suggest that other factors, such as failures to reach threshold performance targets, are driving the Adut et al. (2003) and Gaver and Gaver (1998) results more than the mere absence of bottom-line financial measures in the incentive contracts of loss-making firms.

Evidence from one firm in our sample clearly illustrates the reluctance to set negative targets as a key principle of the bonus program, thereby making the financial performance targets difficult to achieve, particularly when facing steep losses. HomeSoft, a leading international publisher of software game products, places a high emphasis on financial measures of performance, and keeps targets that yield full bonus potential on these measures at positive levels, even during loss periods.

HomeSoft's bonus plan includes two components. The first component, counting for 33 percent of the target bonus, is based on corporate performance: consolidated operating income (COI). If the COI-target is not achieved, this part of the bonus is zero. When the COI-target is exceeded, additional bonus payments are made according to an uncapped and (slightly) convex performance-reward function. (The philosophy in setting the corporate COI-target is to have it be about 95 percent achievable.) The second component of the bonus, counting for 67 percent of the target bonus, is based on individual performance measures, typically four to five, which are specified and tailored by function. However, this bonus-plan element is only funded at 50 percent if the corporate COI-target is not achieved. In other words, if an individual manager performs exactly at target on her individual objectives (which are assessed to be 80-90 percent achievable), but the corporate COI-target is not achieved; the manager will only earn 33 percent (or half of 67 percent) of her target bonus. The bonus system is almost entirely formulaic, with subjectivity limited to some difficult-to-measure, yet important, contributions of managers to firm value.

HomeSoft's Director of Compensation stressed that "we don't want to pay 100 percent of bonus potential for a loss!" For example, even though expected 2003 operating income of one studio (the term for profit center in this firm) was expected to come in at negative \$3.1 million, the target for earning 100 percent of the bonus on this component was still set at positive \$0.5 million. If the studio's profits had come in at negative \$3.1 million, as expected, the manager would only earn 75 percent of the target bonus on this component (which was 25 percent of the total target bonus). However, because of the way the bonus system is designed, the effect of not setting negative targets is potentially more severe when there is a (steep) loss at the corporate level. Nonetheless, the director of compensation explained:

The incentive system is sound and thoughtful as it keeps employees happy without spoiling them.

She further supported her assertion by pointing out that "HomeSoft has insanely low turnover." This suggests that HomeSoft does not face any undesirable retention consequences from their "no profit, no (full) bonus" policy.

As part of our exploration of RQ_{Ia} , we also asked the interviewees *why* they link at least some incentives to bottom-line financial performance measures in loss-making situations. The respondents cited the same basic reason as can be heard in profitable entities; i.e., profits are important, and losses are informative about managers' performances. In the representative words of two of the managers interviewed:

If the firm is doing poorly [meaning profits are down], bonuses are down. People understand that.

At top management levels, we do not allow for excuses.

Examples A and B describe more detailed accounts that show some of the complexities and dynamics in the design and implementation of incentive contracts in loss-making entities. Exam-

ple A describes the experiences of a public firm that weights earnings heavily (75%) in the granting of bonuses. This firm had not yet reported its first profit, but its managers were anxious to do so. This example illustrates how difficult it is to assign a specific weighting of importance to bottom-line financial measures. While the bonus contract mentions an explicit (75%) weighting factor, with the firm reporting losses, token bonuses were still paid in two years, but no bonuses were paid when the firm had a particularly bad year. In another complicating twist, a profit-related vesting contingency was included in the firm's stock option plan.

— Insert Example A —

Example B describes the incentive-system practices of a firm that had historically not used bottom-line financial measures in their allocations of bonuses. If our study had been done in 2001, we would have classified this firm as one that makes no use of bottom-line financial performance measures, for almost any purpose, including cash incentives. While the importance of bottom-line financial measures grew over time, even in 2004 those measures were still relatively unimportant (weighted at 26%) compared to the other measures. The weighting placed on financial measures was growing as the firm readied itself to go public.

— Insert Example B —

In summary, our evidence to address RQ_{1a} suggests that many loss-making entities do link incentives to bottom-line financial performance. What then explains the weak link between bottom-line financial performance and cash incentives observed in prior work? We suggest the following. First, there is quite a large variation in the explicit weights placed on bottom-line financial performance measures in the formula bonus plans of the loss-making entities in our sample. In the eight entities with non-zero weights on financial performance, the weights varied from 26 to 100 percent. A lower weight on financial measures implies a higher weight on other measures,

which severs the strength of the link between financial performance and cash incentives. Moreover, the explicit weights are not always a good indicator of the *de facto* importance of bottom-line financial performance for incentive pay, which further obfuscates the financial performance/incentives link. Second, our evidence suggests that the failure to reach threshold performance targets might also be driving the weak financial performance/incentives link. Specifically, we found that loss-making entities that ascribe to a “no profit, no bonus” philosophy are reluctant to set negative targets, thereby making the financial performance targets difficult to achieve, particularly when facing steep losses.

RQ1b involves understanding what loss-making entities do instead if they don’t base incentives on performance measured in bottom-line financial terms. To address this sub-question, we focus on the minority of entities in our sample (i.e., three firms plus two of the three entities in the profitable firm) that did not base incentives on performance measured in bottom-line financial terms. Variations of the measurement informativeness argument formed at least a portion of the rationale for severing the link between bottom-line financial measures and cash incentives in all of these entities. Why did the managers of these entities make this choice and what incentives did they offer instead?

One of the divisions of the profitable firm we studied provides a nice example of how one variation of the lack-of-informativeness argument severs the link between financial measures and incentive payments. This division is building a business in a new geographical area. Evaluators of the division manager are not concerned with the losses that are being reported. They evaluate the division’s performance subjectively by considering a broad range of performance factors and, in particular, gross margins and growth in sales and company reputation.

The firm, Medical Products Corporation (MPC), is a medium-sized hi-tech firm (annual revenues of about \$500 million) that sells medical products in many locations around the world, mostly through firm-owned sales-oriented divisions, but also through distributors in some locations. In 1997, MPC established a division in Japan. In 2003, earnings were not yet important for evaluating and rewarding the managers of MPC-Japan. The goal for MPC-Japan was to build market share over the initial 5-year period. MPC's VP-International explained: "Losses are tolerated if the long-term prospects are favorable." But while the emphasis was on growth, MPC-Japan's management was also "watching pennies and nickels" in day-to-day expenses. Also from day one, every sale had to have a positive gross margin. In other words, investing in the future, combined with cost savings and positive gross margin sales was the mantra during start up. In its third year, MPC-Japan could have budgeted a profit, but top management did not want its managers do so because they wanted to ensure that needed further investments in the future would not be jeopardized.

Each year since 1997, the general manager of MPC-Japan was assigned a subjective bonus. MPC's VP-International explained that these bonuses were deserved because the business was "clearly taking hold." MPC-Japan's reputation was getting stronger (as measured by a survey), and sales were growing rapidly.

This example contrasted nicely with that of one of the other loss-making MPC divisions that we studied. In that other, more mature division, profits were deemed to be a good indicator of performance. Managers in that division were not given bonuses explicitly because the division was incurring losses.

A second variation of the lack-of-informativeness argument is based on measurement distortions caused by uncontrollable factors (Baker and Jorgensen 2002; Baker 1992). There is a gen-

eral reluctance to hold managers accountable for factors beyond their control (Merchant 1989). If these uncontrollable factors can be forecast reasonably accurately, their effects can be impounded into the performance standards used for making the performance evaluations. But some of these entities operate in highly uncertain environments in which it is difficult to set meaningfully challenging performance standards. In the words of one of the managers interviewed, “We had no clue as to what was going on or what was going to happen.” And in turnarounds, specifically, most decisions and actions are so radically different from what managers have faced before that they have little to guide them (Haveman 1992; Meyer 1982). The same is true for start-up situations, where there is little or no history of means-ends relationships to go by (Romanelli 1989). This significantly reduces the predictability of earnings and makes incentives based on them much more risky.

Example C illustrates several of these circumstances. This example also shows evidence of the risk-limiting argument for severing the link between financial performance measures and compensation, for reasons of managerial retention. Where managers face significant uncontrollable factors or a highly uncertain planning environment, it is likely that incentives that are given, if any, are based on subjective considerations.

— Insert Example C —

Example C also illustrates a political-cost constraint on bonus awards. At this firm, even though performance on the dimensions included in the incentive program was strong before the crisis and continued to be strong during the crisis, warranting bonus payments, executives decided to cut them back. This was due both to the firm’s cash crush and, perhaps more importantly, to public scrutiny (what the Director of Compensation called “the red face test”). So even though “2000 was a great year on all dimensions,” no bonus payments were made to executives

and only minimum payments were made to other employees in 2001 because the crisis had hit by then, and the firm was on the brink of bankruptcy.

A third variation of the lack-of-informativeness argument is related to the quality of internal accounting systems. One firm, a manufacturer of high-end barbeque equipment (Gradient Grills), did not have an effective financial reporting system. The firm was generating about \$8 million in annual revenues, but it was losing about \$2 million per year. The management team was almost exclusively sales oriented. Turnaround specialists brought in to overhaul the firm's fortunes concluded quickly that they could not trust the firm's financial systems. One said, "You can't believe the financial statements or any data in the firm." Indeed, the systems were primitive. Cost of sales was defined simply as just what the firm bought during the month, and Gradient Grills did not have a working inventory system. The turnaround specialists started their intervention process by building their own simple bill of materials and MRP system on an Excel spreadsheet.

The turnaround specialists soon found that Gradient Grills was, in fact, losing money on almost every sale. The firm had not secured good prices for its materials purchases, and its manufacturing processes were inefficient. One of the early goals set was to reduce the parts cost by 20 percent. They did not yet know if this goal was feasible, but they knew that if the firm did not reduce its costs significantly, a healthy turnaround would be difficult. Among the measures to which the turnaround specialists were paying the most attention were sales, cash expenses, collections, and purchases. All of these items had a direct and immediate impact on cash flow, something that was in short supply.

In summary, our exploration of RQ_{Ib} suggests that managers of loss-making entities use several reasons for not basing incentive contracts on performance measures in bottom-line financial terms. Lack of informativeness of the financial measures is a common reason. Financial meas-

ures might not be informative of managerial performance because accounting earnings do not reflect the value created in pre-profit firms, because the measures are affected significantly by uncontrollable factors, and/or because the financial system is not effective. Firms might also sever the link between financial measures and incentive awards when it is impossible to set meaningfully challenging performance standards to use for evaluation purposes and/or when managers perceive that it would be awkward to be seen giving bonuses when losses are being reported.

Research Question 2

RQ_2 asked if these practices or explanations vary systematically across settings. Dividing our already small sample into finer partitions allows us to make only tentative hypotheses, but we suggest the following.

First, the importance of positive short-term earnings (and cash flows) is more important in some loss-making entities than others, and this importance is reflected in annual bonus contracts. Where are short-term earnings more critical? On average, earnings seem to be more important in publicly-traded firms (see Example A), or those that want to be in the near future (see Example B), than in privately-held firms or divisions of publicly-traded firms (Price Waterhouse 1995; Barry et al. 1990). Privately-held firms often have owners that are more patient than the shareholders of public firms. Losses at the division level can often be tolerated for a while because they do not put the firm as a whole at significant risk. Earnings are also more important in distressed firms that need infusions of cash or reductions in expenditures to survive (Gilson and Vetsuypens 1993). Firms that are in survival mode often place an extremely high importance weighting on bottom-line financial measures to motivate employees to bring in the needed profits (by enhancing revenues and/or cutting costs) and, hence, cash.

Second, earnings seem to be less important in pre-profit entities, although this importance appears to depend on the stage of the entities' business/product development. Pre-profit entities are young entities whose managers are building a business. They are making investments that they hope will pay off in the future. But accounting rules require immediate or rapid expensing of those investments. Thus, with revenues lagging and expenses accelerated, these entities almost inevitably find themselves in a loss position where the reported loss does not adequately reflect all of the anticipated future consequences of their current business-building decisions (Engel et al. 2003; Ittner et al. 2003). Reducing losses in pre-profit firms, therefore, might mean only that managers have reduced their needed business-building investments.

Examples A (HTC) and B (TSI) are both pre-profit firms. To prevent a myopic focus on earnings, TSI managers emphasize measures that reflect the building of their business, such as the various nonfinancial and specific line-item financial measures (revenues) shown in Table 1. TSI is a young firm, and profits really could not have been expected so soon, particularly for a firm trying to sell to the slow-to-change automotive industry. But patience, particularly on the part of the venture capitalists, is declining and, apparently as a direct consequence, the importance of financial measures in the bonus plan is increasing (Price Waterhouse 1995; Barry et al. 1990). At HTC, in contrast, the investors and managers focus on earnings; they have waited many years for the company to become profitable. A lack of a short-term focus (failure to become profitable soon) would limit access to capital and jeopardize the long-term prospects as much as an undue emphasis on the short-term in the case of TSI. Therefore, HTC managers are driving their company in financial terms in hopes of accelerating the path to profitability.

HTC also has been in business longer, is closer to profitability, and seems to have a better handle on its operations than does TSI. Thus, HTC managers can rely more heavily on financial

measures to monitor operational performance. Only if the bottom-line financial measures show problems do they have to delve into the detail of the causes of the lack of financial success. TSI's evolution is also consistent with this observation. TSI began focusing more on financial performance as they were evolving from a predominately R&D-oriented focus to a customer- and revenue-oriented focus. As firms evolve in this direction, bottom-line financial performance measures (earnings) become timelier; that is, current earnings measure the performance implications of actions taken in the current period. By implication, this reduces non-financial measures' main purported advantage, that of being leading indicators of forthcoming financial performance (Banker et al. 2000; Ittner and Larcker 1998).

Thus, our analysis of our pre-profit entity examples leads to the same conclusion; that is, as value creation shifts over time from business development to execution, bottom-line financial performance measures become more important. As such, HTC and TSI only appear to be at different stages of developing their business. This conclusion is also consistent with the observations from the pre-profit situation at the divisional level we studied (MPC-Japan).

Third, a common element in both pre-profit and financial-distress firms is low cash compensation for managers, which has effects on the entity's ability to attract and retain key managerial talent. The pre-profit and distress situations prevent paying high, or even competitive, cash compensation simply because these firms cannot afford it. In public firms, one common solution to the problems caused by declining incentive pay without straining cash flows is to grant additional stock options (as shown in Example A). But it is not clear how much value stock options have when the firm's future is highly uncertain. If stock options are granted, it is not clear if they have any value unless the firm survives and goes public at some future time (as illustrated in Example B). An alternative in these situations is to provide higher bonus potentials, but given the

distressed/pre-profit firms' uncertain and volatile situations, highly-leveraged incentives make the "downside risk" for hard-working managers often too high (Baker and Jorgensen 2002; Baker 1992). In summary, the limited ability to provide a meaningful overall compensation package in pre-profit and distress situations generally puts enormous strains on the firm's ability to retain key people, particularly at a time when they are needed the most. This was a recurring theme in all of the pre-profit and distress cases.

But firms facing losses that are thought to be transitory also are concerned about retention, particularly if their losses are severe, as in Example C. But when these firms are publicly-traded, they can give managers various forms of equity, such as stock options and restricted stock, to encourage employee retention. Moreover, firms running transitory losses may not be as cash constrained as pre-profit and distress firms, so that they can also make cash payments for retention purposes. Such payments, however, tend to be based on a subjective evaluation of performance instead of being tied to current bottom-line financial performance.

Other entity characteristics also seem important in affecting incentive payments. Public firms face possible political costs if they pay bonuses while losses are being incurred, as can be seen in Example C. Private firms face far fewer of these pressures. And it seems to matter whether privately-held firms are managed by the owner. In owner-managed firms, the owner and key members of the management team are generally tied up in the situation emotionally. Although short-term pay in these firms is often viewed as less of a concern (compared to the importance of saving the firm), turnarounds, which might involve the discontinuance of existing incentive programs, are often very difficult because "the drastic changes that are proposed are invariably interpreted as if everything that management has done before was wrong" (quote from an interview at Gradient Grills).

In summary, our exploration of RQ_2 suggests that many factors can affect firms' decisions to link incentives with bottom-line financial measures, or not. One factor is the importance placed on reporting positive earnings (and cash flows) in the short-term. This importance tends to be higher in publicly-traded firms or those that want to go public in the near future and in firms that are in survival mode. It tends to be lower in both loss-making firms that are in an early pre-profit stage of development and lower-level organizational entities (e.g., divisions). Another important factor is the entity's need to attract and retain key managerial talent. If that need is high, bonuses may be given subjectively even when the entity is reporting losses. If the corporation is highly cash-constrained, those bonuses are likely to be in equity form. And ownership structure is also important. Publicly-traded firms are more likely to face political costs, but they can give managers various forms of equity.

DISCUSSION AND CONCLUSIONS

This study was designed to explore questions raised by the previous finding of lack of links between bottom-line financial measures and annual bonus payments in loss-making entities. We wanted to understand better why the links did not exist and what incentives loss-making entities offered their managers instead, if any.

In a surprise, we found that most loss-making entities do include formally, or consider subjectively, bottom-line financial measures in their assignments of bonus awards. It is simplistic to say that loss-making entities do not motivate their managers with incentives linked to bottom-line financial performance measures.

We discovered many possible explanations for the previous finding of weak links between accounting earnings and short-term bonus awards. Using the field study research method, we were able to provide direct evidence to support some, but not all, of the conjectures proffered by

researchers who had discovered this weak link. We also provide some detailed examples to illustrate real world practice, and its complexity, in this important, accounting-related area.

Weak links between accounting earnings and short-term bonus awards have many possible causes. One is clearly the lack of informativeness of the bottom-line financial measures in certain situations. We illustrated three types of loss of informativeness that are probably more common in loss-making entities than in profitable entities. One is caused by an inherent weakness in the accounting model, which requires immediate or rapid expensing of developmental investments. This model does not yield economically meaningful profit measures in start-up times. Nonfinancial or highly specific financial measures of outcomes, such as R&D successes, market share increases, and revenues, are often deemed to be more indicative of value creation in these situations. A second type of low informativeness is caused by the presence of a combination of significant factors that are deemed uncontrollable by the managers of those entities plus high environmental uncertainty that makes it impossible to impound estimates of the effects of these factors into the performance targets used for evaluation purposes. To avoid this problem, many evaluators based incentive awards on other (particularly nonfinancial) measures that are less subject to the distortions of uncontrollable effects, or they resort to evaluating performance subjectively. Subjectivity allows them to take a broad range of factors into consideration after the evaluation period has ended in reaching their evaluative conclusions. A final type of informativeness failure is simply that financial information in troubled firms sometimes cannot be trusted because of system weaknesses, such as a lack of adequate internal controls.

A second cause of the weak links between financial measures and incentive payments occurs where bottom-line financial measures are explicitly included in managers' bonus contracts but

incentive awards might not be paid because the entity failed to reach threshold levels of performance. Entities reporting losses are likely to be operating below those (positive) thresholds.

A third cause of the weak links between financial performance and bonus payments stems from a use of the bonus system for managerial retention purposes more than for incentive purposes. If retention becomes a primary concern, then evaluators sometimes act to limit managerial risk, such as by subjectively assigning bonuses in the face of losses.

Finally, political concerns can sometimes cause firms not to pay bonuses that bonus formulas suggest should have been paid. This is more likely in publicly traded firms.

We did not hear any examples that pointed to either managerial entrenchment or labor market competitiveness as major causes of the severing of links between bottom-line financial performance measures and incentive payouts. We cannot determine whether these are relatively unimportant or rare causal factors, or whether the managers we interviewed did not want to identify them as causal factors. And indeed, management entrenchment can easily be rationalized by evaluators who prefer to see their actions as limiting management risk. It is difficult to separate these two factors. Perhaps an innovative research design can separate them and definitely identify the empirical significance of the entrenchment factor.

The above discussion summarizes the most important general factors explaining variance in the choices of performance measures in loss-making entities. We also observed that the effects of these general factors are moderated by some entity characteristics. One is the type of loss-making situation being faced. Pre-profit firms face significant problems of financial measure un-informativeness, but if the pressure for financial performance grows, such as because of an impending initial public offering, the emphasis placed on financial performance measures increases significantly. Firms facing transitory losses tend to be most concerned about managerial reten-

tion. While they do not want to make normal bonus payments in their loss-making periods, they do sometimes make cash payments for retention purposes based on subjective considerations.

Other entity characteristics also moderate the relationship between financial measures and incentive payments. As compared with privately-owned firms, public firms face greater pressure to report profits, and they can offer stock-based incentives that are easier to value. Losses at the division level are often tolerated for longer periods, if good decisions are being made, than are losses at the corporate level. Shareholders are often more impatient and persistent corporate losses can put the firm's survival at risk. And owner-management sometimes makes it more difficult to face up to losses.

Further studies in this area might reveal other important contextual factors that were not apparent in the limited number of settings studied here. While we studied a broad range of loss-making entities and possible explanatory factors, we acknowledge that our scope of examination was quite limited in that we systematically focused on only one dependent variable, the relative use of bottom-line financial measures of performance. It would also be interesting to focus on other characteristics of performance measurement and incentive systems in loss-making entities, such as the size of incentives paid; the form of payment (cash, equity, options); and the use of individual vs. group performance criteria. Also, we studied only a small sample of loss-making entities; and our selection of sample firms and principal informants was opportunistic. Nevertheless, we believe that our field study has enhanced our understanding of uses of performance measures and incentives in loss-making entities. Future research addressing some of these limitations in our scope of examination could further advance our state of knowledge in this important area.

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Appendix A

Information about the Purpose and Scope of Questioning Sent to Some Interviewees

Thank you for agreeing to participate in our academic research on how firms use their performance measurement and incentive systems when they fall into a loss-making situation. We have funding from the KPMG Foundation for our project. We know [firm] went through a loss-making period. [*We tailored this last sentence to the type of loss-making situation the firm was facing, i.e., pre-profit, transitory loss, or financial distress.*]

The purpose of the research project is to understand if a loss-making situation affects firms' performance measurement and incentive systems, either their design or the ways in which they are used. We would like to explore questions like the following with you:

1. When [firm] faced “challenging times” (ran losses), did the importance of financial measures of performance (e.g., profits), as compared to other performance indicators, change? (We're not exactly sure how to assess this importance, but it could be reflected in the discussions during management performance review meetings and/or the design or implementation of incentive plans.) Did the role of nonfinancial measures of performance change during this period? If so, which of these measures became more important?
2. During the challenging-times period, did the firm change its incentive plans for the executives? For lower-level managers? If so, why and how? Related to this are, of course, some questions about the detail of existing incentive plans, and if they changed, some “before/after” detail.
3. What were (would be) the main arguments for changing incentive plans when facing “challenging times” (running losses)? What were (would be) the main arguments for keeping incentive plans unchanged?
4. Would your arguments for/against change be affected by whether the challenging times are “transitory” (i.e., not expected to last for an extended period, e.g., two or more years) or “structural” (e.g., putting the firm at risk of prolonged financial distress)?
5. What are the main concerns that incentive plans should address during periods of transitory vs. prolonged financial distress? Motivation (i.e., encourage managers and employees to work hard(er))? Retention? Provide competitive pay? Cost savings?

While we hope to be able to talk about some specific [firm] practices, we will not publish or otherwise disseminate any undisguised information that we gather from you without explicit written permission. We can't imagine that we would bump up against any proprietary hurdles, but we will be glad to give you any promise of confidentiality that you need. We are not going to compete with [firm], and we have no ties to any other firms in your industry. But more generally, if researchers like us abused your confidentiality rights, we would soon be unable to do our work. We have been doing field research in many firms, and we have been careful not to abuse the privileges we have been given. We will be glad to provide references if you want to check them. We also respect your right to declare certain topics or information off limits if you so choose.

Example A

HyperTechnologies Corporation: *Profits are Important*

Contract Design

HyperTechnologies Corporation (HTC) places a high weighting on earnings. HTC was founded in 1987. It launched its first commercial product in 1997. HTC's revenues are now growing rapidly, well over 50 percent per year, but the firm has not reported a profit in any quarter of its 17-year history. Although the firm is listed on NASDAQ, most of its funding has come from private investors. Management knew that raising more money would be difficult until and if the firm started earning profits.

The compensation package for HTC's top 30 people is comprised of three elements: base salaries, cash bonuses, and stock options. HTC's salaries are set at competitive levels. For most employees, annual raises range from 0-5 percent based on annual performance reviews that result in a ranking of employees.

HTC's bonus plan provides cash awards up to a maximum potential of 40 percent of base salary based on the achievement of a weighted combination of firm and individual objectives. Firm performance, weighted 75 percent, is evaluated in terms of earnings. Individual performance, weighted 25 percent, is evaluated in terms of achievements in 4-9 performance areas that are tailored to each individual's area of responsibility. Examples of such achievements are successful accomplishment of project milestones, establishment of needed lines of credit, and maintenance of receivables at less than 28 days outstanding.

Annually, all HTC employees are also given stock options. The purpose of the option plan is to promote the success and enhance the value of the firm by linking the personal interests of participating employees to those of the firm's stockholders and by providing such employees with an incentive for outstanding performance. The details of the stock option plan have been modified somewhat over the years, but all the options granted are 10-year options, 25 percent of which typically vest after one year, and the remaining 75 percent vest gradually every month for the following 36 months. The number of options granted varies depending on organization level and tenure. Lower-level employees are given only a few, perhaps 200, options per year; top-level managers receive thousands of options annually.

Implementation

In 2000 and 2001, HTC paid bonuses, but only up to a maximum of about 20 percent of base salary (i.e., half of the bonus potential). For the year 2002, HTC set an aggressive revenue and earnings plan, but the firm did not come close to achieving it. As a result, management implemented an across-the-board salary cut of 10 percent and mandated that no bonuses be paid.

To help ensure that HTC did not lose its key employees, and to drive employees to focus on having the firm become profitable, HTC managers implemented a new stock option plan in March 2003. With both purposes in mind, they added to the plan a unique performance-

dependent accelerated vesting feature. The options would “cliff vest” after 5 years (that is, all the options would vest on January 1, 2009). The vesting, however, would be accelerated to 50% on January 1, 2004, and 50% on January 1, 2005, if the firm was profitable in the fourth quarter of 2003 and if the profits were judged to be sustainable. HTC’s CFO summarized by stating that, “The big message in this firm is *sustainable profit*, and hence, we’re looking at that quarter after quarter after quarter. We must get there, and it better be sooner rather than later.”

Example B

Technical Solutions, Inc.: *Profits are Becoming More Important*

Technical Solutions, Inc. (TSI) is a firm that links earnings formally to incentive awards but does not weight them highly in importance. TSI was founded in 1996. Using a new technology, TSI is developing new emission control products and is trying to sell them initially to firms in the automobile industry. Every TSI employee's compensation package consists of three components: base salary, bonus (introduced in 2001), and stock options.

Elements of Compensation

Base salaries are set slightly below the industry median. The spread between the top and bottom salaries in the firm is not large, and salary raises are modest, typically in the 4-5 percent range.

TSI's annual bonus plan was put in place in 2001 to communicate the importance of short-term goals to employees and to align their interests with the firm's objectives. Some employees also appreciated the cash bonuses, which are more immediate and "tangible" than the stock options. The target bonus can be from 5-15 percent of an employee's base salary depending on the employee's level within the firm. All bonuses are awarded based on firm, not individual, performance because "we want a team effort; we all win or all lose together," the CFO explained.

Each employee is given stock options when they join TSI. The options vest over the first 4 years at 25 percent per year and expire 10 years after granting (or within 30 days of leaving the firm).⁴ Follow-on grants are awarded on an adhoc basis to ensure that employees' stock holdings are in line with their current position and contribution to the firm. The value of the stock option component varies substantially depending on tenure, position in the firm, and contribution to the organization. By 2002, employees (most of them were hired during the 2000-2002 period) had on average accumulated value in stock options worth 50 percent of their annual salary. The employees, in total, owned on a fully diluted basis about 24 percent of TSI shares.

Evolution of the Bonus Plan

Table 1 shows the performance areas linked to bonuses in the years 2001-2004. The measures reflect firm-wide achievements in five areas: financial performance, order commitments, execution of existing business, quality, and building of infrastructure. Financial performance is reflected both in terms of revenues and operating income. Order commitments included a number of specific programs that TSI managers felt they had the opportunity to bid for that year. If the manufacturer made the order commitment to TSI, TSI employees would earn that designated portion of their target bonus. These programs were weighted in importance by size. Execution of existing business was assessed in terms of shipment volumes to customers. Quality was measured in terms of scrap, shipment errors, and proportion of on-time deliveries. Finally, the build-

⁴ The exercise price of stock options is based on independent valuations obtained during recent financing rounds.

ing of infrastructure referred to the implementation of mass production facilities, attainment of certifications (QS-9000, ISO-14001), and the completion of safety training, all of which were important in TSI's early years.

Table 1
Performance Measures and Importance Weighting for Bonus Purposes
Technical Solutions, Inc., 2001-04

	2001	2002	2003	2004
1. Financial performance				
- Revenues	0%	18%	15%	26%
- Operating income	0	18	15	26
2. Order commitments	45	46	30	37
3. Execute existing business	37	0	29	0
4. Quality	9	9	11	11
5. Build infrastructure	9	9	0	0
	100%	100%	100%	100%

In an interview in 2002, the CFO predicted that the importance of financial measures would probably increase in the future as TSI came closer to becoming a public firm. However, he also said that “he would be shocked if their importance ever exceeded 50 percent.” In 2004, however, the two financial measures—revenues and operating income—were weighted slightly greater than 50 percent. The CFO said the pressure to increase the importance weightings on the financial measures was coming from the venture capitalists, who were getting impatient for returns on their investments. TSI managers, however, were still more interested in focusing on the operational indicators of success.

Example C

California Power Corporation: *Profit, Retention and Political Concerns*

California Power Corporation (CPC) is an electric utility serving a portion of California that deemphasized the importance of earnings when it faced significant transitory losses. CPC uses two main types of short-term incentive programs: a *Results Sharing Program* (RSP) and a set of incentives that are collectively referred to as the *Executive Compensation Program* (ECP).

Incentive System Design

All permanent employees, except the top executive group, are included in the RSP, which is designed to help focus employees on activities that have an impact, both direct and indirect, on the firm's success. Two main factors determine RSP-payouts: business unit performance and firm performance. First, the performance of the business unit to which the employee is assigned is measured in terms of the degree of accomplishment of a type of balanced scorecard comprised of goals in five areas. Performance on the financial dimension is always weighted 25 percent of the total. The key financial performance indicator is typically accomplishment of the budget for operating income excluding extraordinary items. Some financial sub-goals, such as for specific revenue or expense line-items, might also be identified. The other four goals, all nonfinancial, are chosen and weighted by business unit management. Common measures are safety, service reliability, customer satisfaction, and specific key performance indicators such as program accomplishments. The performance on each dimension is assessed in terms of whether the goal is achieved, or not. Thus, for example, if a business unit's safety goal is given a 20 percent importance weighting and the goal is not achieved, then personnel in that business unit would receive only a 0.80 business unit rating even if all of the other goals are achieved. Second, firm performance is measured in terms of percent achievement of corporate annual operating income. This percentage is translated into a multiplier of the business unit award rating based on a translation table set annually.

All executives at vice-president (VP) levels and above are included in the ECP. The program has three elements: base salaries, bonuses, and long-term incentives. The levels for all three elements are targeted at median levels for comparable jobs among industry peers. For senior executives, the peer group is comprised of 13 deregulated, diversified electric utilities.

Bonus payments are based on the achievement of both overall firm and individual objectives. Target bonuses range from 30 percent of base salary for some VPs at the business unit level to 80 percent of base salary for the Chairman and President/CEO. Maximum opportunity levels are set at 200 percent of target award levels. The bonus plan also allows for the possibility of additional awards for "special recognition of accomplishment and for retention purposes."

CPC's long-term incentives are comprised 75 percent of 10-year nonqualified stock options and 25 percent performance shares. The size of the long-term incentive awards varies by level, guided by surveys of peer firm practices. Stock options are granted to executives plus 300 non-executive managers. The performance shares pay out at various levels based on CPC's total shareholder return as compared to peer utility companies over a 3-year period.

Implementation

In 2000, CPC suffered a transitory loss of over \$1 billion. The seeds for this loss were sown when California deregulated the retail electricity market in March 1998, which operated smoothly until May 2000, but then it collapsed. Fueled by an increasing population and a strong economy, demand for electricity in California was growing at an average annual rate of 6 percent. Because of the high demand but no increases in supply (no new major power plants had been built in the prior 10 years), supply became short. Wholesale energy prices, which were now deregulated, rose dramatically.

Most of California's power utilities, including CPC, were squeezed. The rates they could charge to retail customers were fixed, but their costs were rising sharply. The state regulatory policy had forced them to sell their fossil fuel power plants, so they were required to buy the needed electricity on the volatile spot market at rates that were soaring. In 2000, the utilities were buying electric power at costs that were, on average, five times higher than the rates they could charge their customers.

What effects did these events have on CPC's performance measurement and incentive systems? By the standards of the RSP, 2000 was a "great" year, even though it was the first year of the crisis. The payouts for 2000, however, were made in 2001 at which time CPC was teetering on the edge of bankruptcy. The Board and management were reluctant to make the called-for RSP payments, approximately \$65 million, at the same time they were "screaming bankruptcy." They decided to delay the payments citing the "uncertainty" to the employees. In June 2001, then, they decided to pay out only minimum amounts. No employee objections were heard because "everyone knew we were in deep trouble."

The Compensation and Executive Personnel committees of the Board approved no executive salary increases for 2001, and they delayed all employee raises by 3-4 months. They approved only "special" bonus payments to two executives "in recognition of their significant contributions in 2000 to preserve the viability of the firm during the financial crisis, and for retention purposes."

The long-term incentive awards suffered dramatic decreases in value. The fall in the stock price destroyed all embedded value in outstanding stock options and, combined with the suspension of dividends, rendered the performance shares valueless.

In March 2001, the Board committees changed the bonus plan into a retention incentive plan. These awards were not tied to performance as goals were seen to be "quite unclear." The payments were earned if an executive remained actively employed through the performance period. The retention incentives were set equal to target bonus levels (30-80 percent of salary). For lower-level executives, these awards were paid quarterly in cash. For more senior executives, the payments were in the form of half cash and half deferred stock units (DSUs), convertible into shares of CPC stock after 2 years. At the most senior level, all of the awards were in the form of DSUs. CPC's Director of Compensation explained why the link between performance and bonuses was severed:

Our traditional financial measures became meaningless. We knew we needed to keep the lights on, so our traditional operating goals (reliability, customer satisfaction, and safety) remained important, and our performance there remained excellent. But we were in a new world where cash was king, and the challenge was so enormous that we couldn't cost-cut our way out of it. More important was creating a path to resolution via the regulatory process, rather than pursuing bankruptcy.

In May 2001, the Board attempted to counter the drop in stock price by issuing a second option grant. This essentially pulled forward the grants that were to be made in 2002 and 2003. There were to have been no additional grants in those years. But the price continued to fall. In October 2001, CPC then offered an exchange to personnel who had received option grants in 2001. They could turn in their options and receive DSUs equivalent in value to the Black-Scholes value of the option at the point of exchange, which was lower than the value at the grant date. These DSUs could be converted to shares of stock between 2002 and 2005.

In 2001, while CPC returned to profitability, the firm's operating performance was not good. The firm faced serious issues, such as the failure of a turbine in a power plant and a significant power outage in California. The firm failed to achieve its financial targets. All incentive awards for 2001 were paid at minimum amounts. However, 2001 did mark the end of the crisis.

The year 2002 was a good one. Incentive awards returned to "good" levels. For example, in 2002, the CEO earned \$6 million in salary, bonus, stock, and other compensation, up from \$2.7 million the year before. But this caused another concern to surface: Activists criticized CPC harshly for providing the high 2002 compensation payments at a time when CPC customers were paying high rates to settle the debts from the crisis just-ended. Management countered by citing comparable pay at peer firms, the firm's stock performance, and a long list of managerial accomplishments, including strong earnings, leadership through the energy crisis, the favorable settlement with regulators, and a series of effective cost cutting and restructuring actions.