

# *The Law of Unintended Consequences: Performance Metrics & Strategic Decisions*

Catherine Dovey, MBA, CCP, SPHR  
Chief Compensation Officer

Dave Wittenberg, MBA  
Principal



V E R A X  
P O I N T

# Speakers' Backgrounds

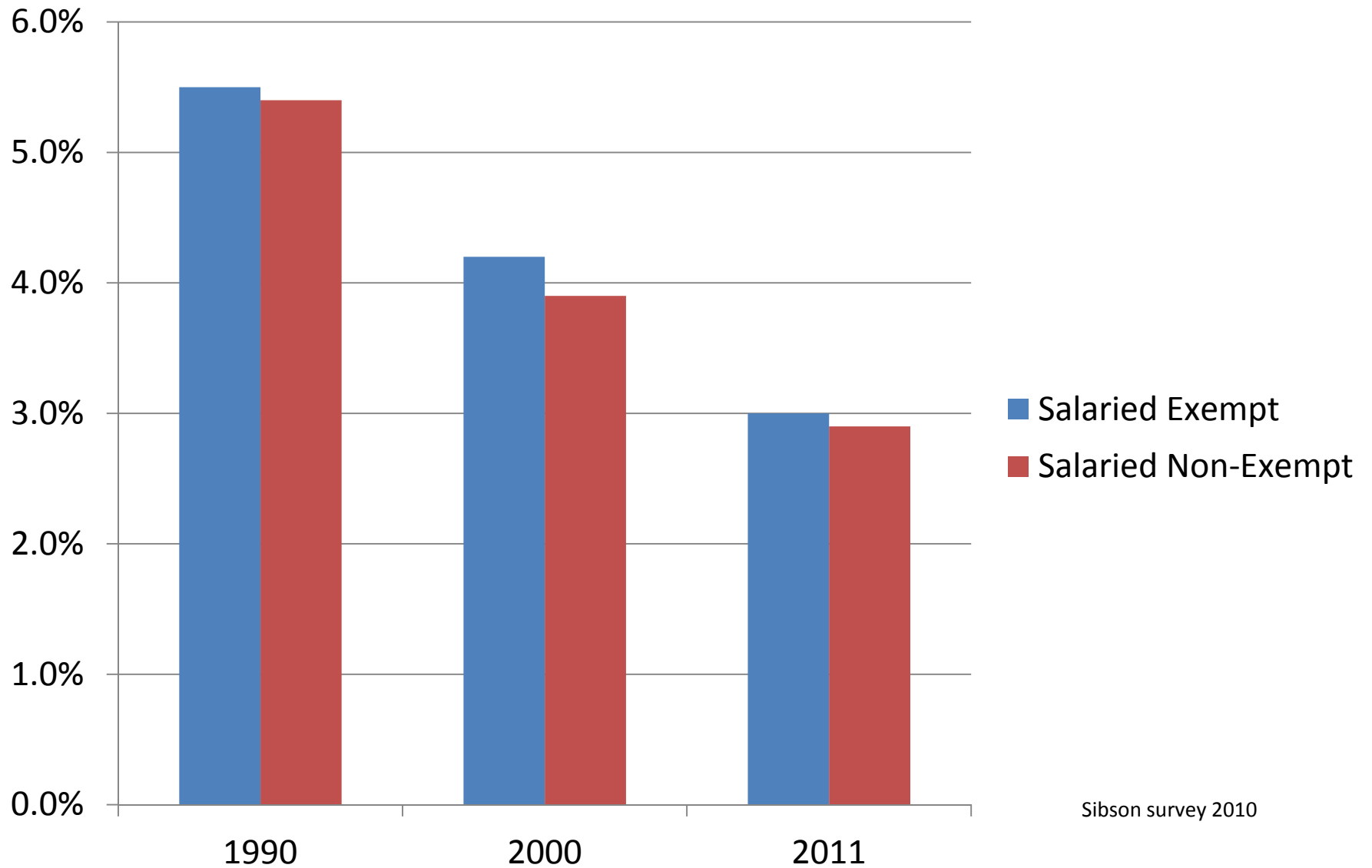
## Catherine Dovey

- CCP, SPHR and MBA
- 20 years with compensation as primary specialty
- Wide industry experiences including professional services, high tech, bio tech, health care, financial services, manufacturing, public sector, non-profit, education
- Past SHRM Total Rewards Panel member  
(only 10 every 3 years)

## Dave Wittenberg

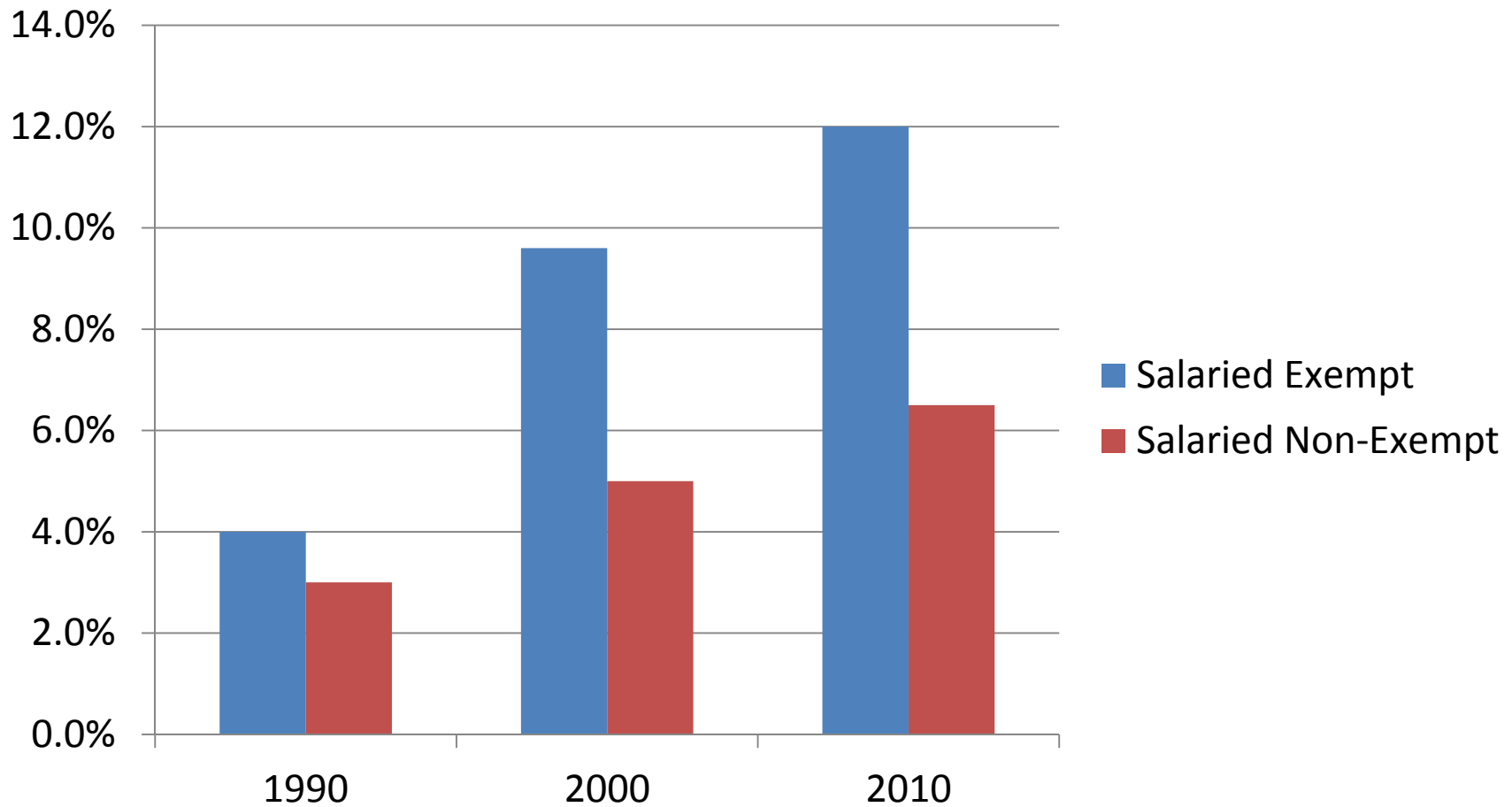
- MBA
- 20 years of management and finance
- Wide industry experiences small family business, forest products and manufacturing, transportation, residential construction, private equity alternative investments
- Teaches management and finance at Pacific Lutheran University

# Base Salary Increases In Decline



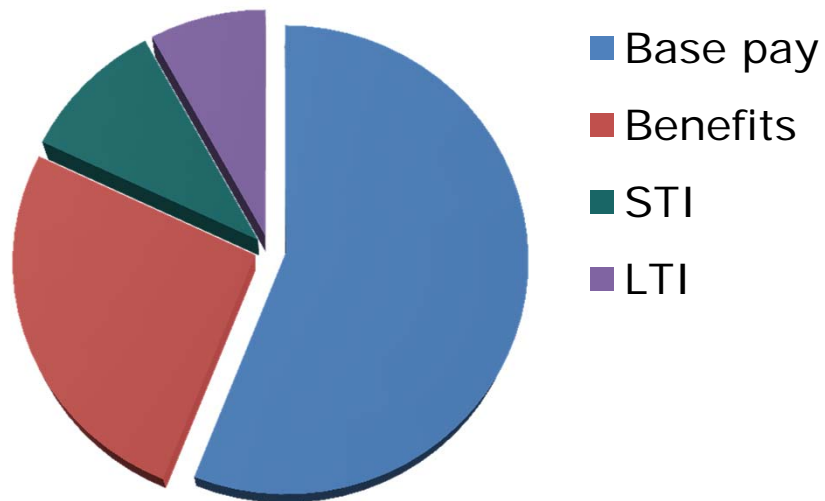
Sibson survey 2010

# Variable Compensation Increasing

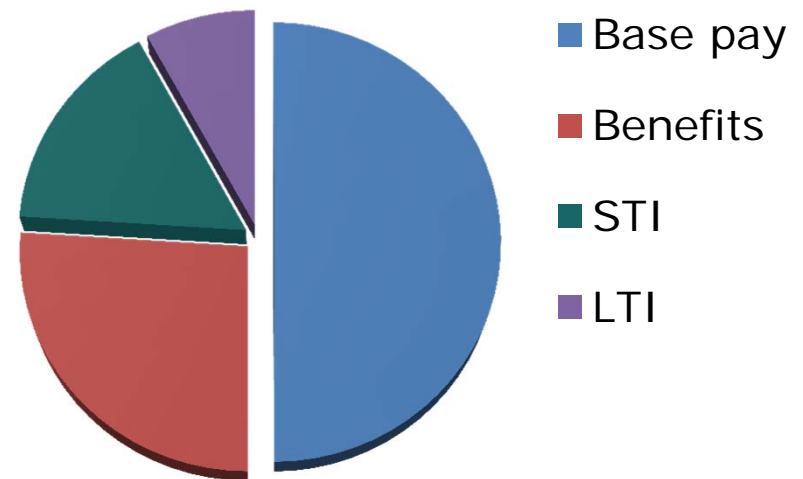


# Expand Incentives – Align Revenue with Expenses

## Today



## 2020



# UNINTENDED CONSEQUENCES



**Performance  
Metrics  
&  
Strategic  
Decisions**

# Want Strategic Recommendations & Decisions To Be:

- Innovative
- Value-Creating
- Objective



# Common Sources of Unintended Consequences

Goal

≠

Finance  
Nerds



# Common Sources of Unintended Consequences

## 1) Self-Serving Bias / Personal Benefit

- Example 1:  
Local Optimization
- Example 2:  
Acquisition Bonus



# Project Tips

## Self-serving Bias / Personal Benefit

- Inform the financial analyst is of the incentive structures represented on project teams.
- Every team needs at least one objective, independent and influential member



# Design Tips

- Design team make-up
- Design team charter
- Create retention bonuses that reward a successful analysis/decisions, not a transaction



# Common Sources of Unintended Consequences

## 2) Accounting Distortions

- Example:  
Cost of Capital



# Accounting Costs - Depreciation

## Scenario:

- Invest \$1 million in R&D or purchase \$million of equipment
- Increase Sales & Revenue by \$1,000,000 for 20 years
- Material costs \$500,000/yr.
- Labor costs \$300,000/yr.
- Spread the cost of the R&D or equipment over 10 years ( $\$2,000,000 \div 20 = \$100,000$ )

## Annual Income Statement

Revenue		\$1,000,000
Costs		
Material	\$600,000	
Labor	200,000	
Depreciation	<u>100,000</u>	
Total Costs		<u>\$900,000</u>
Earnings		\$100,000

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# Accounting Costs - Depreciation

What about your Home?

- Purchased it for \$300,000
- Took out a 5%, 20 year mortgage for \$300,000
- Is your annual cost

$$\frac{\$300,000}{20 \text{ years}} = \$15,000/\text{yr.}?$$

**Why not?**



# Accounting Costs - Depreciation

- There is a cost to using someone else's \$300,000
- Monthly payments for a 5%, 20 year mortgage are  $\approx$ \$1,980/month or \$23,758 per year

$$\$23,758 \stackrel{?}{=} \$15,000$$

- This is at 5% interest, what about at 14% that's closer to the real cost or opportunity cost of capital of businesses in this economic climate?

# Accounting Costs - Depreciation

Recalculate the capital cost

- ~~$\$2,000,000 \div 20 = \$100,000$~~
- \$2 million at 15% over 20 years

**Annual Cost**  
**\$316,000**

## Annual Income Statement

Revenue		\$1,000,000
Costs		
Material	\$600,000	
Labor	200,000	
<b>Capital Used</b>	<b><u>316,000</u></b>	
Total Costs		<u>\$1,116,000</u>
Financial value created / (lost)		(\$116,000)

**Accounting  $\neq$  Finance**

# Common Sources of Unintended Consequences

## 2) Accounting Distortions

- Example:  
Cost of Capital



# Project Tips

- Ensure teams use the right finance tools, not accounting tools, for project decisions.



# Design Tips

- Provide a policy for adjusting incentive targets when the best solution hurts incentive metrics.
- Run pro formas with sensitivity analysis for various scenarios. (Who will do this?)



# Common Sources of Unintended Consequences

## 3) Neglected Risks



# Common Sources of Unintended Consequences

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– Example 1:

No Consequences



# Common Sources of Unintended Consequences

## 3) Neglected Risks

- Example 1:  
    No Consequences
- Example 2:  
    Risk & Return



# Common Sources of Unintended Consequences

## Calculating Returns

Annual Profit  
Boeing Assets

All Boeing Built:

$$\frac{\$1,000,000}{\$5,000,000} = 20\%$$

Heavily Outsourced:

$$\frac{\$800,000}{\$2,000,000} = 40\%$$



# Common Sources of Unintended Consequences

Calculating Returns

$$\frac{\text{Annual Profit}}{\text{Assets}}$$

All Boeing Built:

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# Common Sources of Unintended Consequences

## 3) Neglected Risks

- Example 1:  
    No Consequences
- Example 2:  
    Risk & Return



# Project Tips

- If you hear the term “Financial Engineering”:  
Be afraid... Be very afraid!
- Benefits are rarely free.  
Be skeptical if costs are low or non-existent
  - Keep asking questions

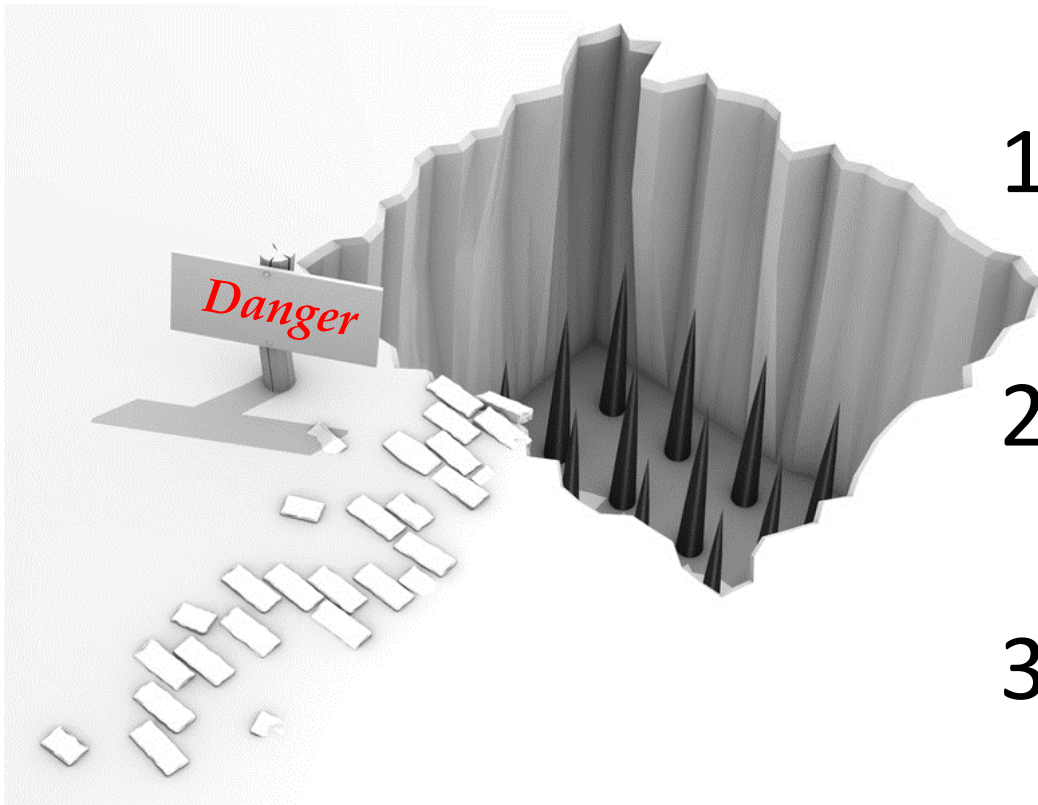


# Plan Design Tips

- Build incentives with balanced metrics that include qualitative and quantitative outcomes
- Consider a longer measurement period – 3 or 5 year look back



# RECAP: Common Sources of Unintended Consequences



- 1) Self-Serving Bias / Personal Benefit
- 2) Accounting Distortions
- 3) Neglected Risks

# RECAP: Project Tips

- Develop your relationship with the CFO and Finance Department
- Be aware of major projects and potentially biasing incentive structures present
- Educate middle and senior managers of the potential problems



# Corporate-Level Compensation Performance Metrics

Performance Measure	Percent of Companies
Revenue Growth	63%
	37%
	32%
EBITDA	32%
EBIT	16%
Turnover / Retention	13%
Total Shareholder Return (TSR)	12%
Reduced Expenses	11%
Return on Investment	10%
Other*	19%

Dave – not sure if this adds value or not. I have no other metric similar to this on number of measures by category

\*Note: Included in the "Other" category are items such as market capitalization, market share, return on assets, return on equity, and earnings per share.

## Number of Compensation Performance Metrics

Job Function	Median Number of Measures by Category		
	Company Performance	Team Performance	Individual Performance
Executives	2	1	3
Human Resources Professionals	2	1	4
Product Research & Development Professionals	1	1	3
Customer Service & Support Professionals	1	1	3
Sales Representatives	1	1	3
Accounting Professionals	2	1	3

# RECAP - Incentive Design Tips

- Identify a clear purpose for any incentive plan
- Design team;
  - Include HR and Finance
  - Informal leaders and worst critics
  - Robust charter
- Run pro-formas and models including sensitivity analysis
- Provide a policy for adjusting incentive targets when needed.



# Incentive Design Tips

- Include extra merit award policy
- Balance qualitative and quantitative metrics
- Consider a longer measurement period – 3 or 5 year look back



# Questions



- **Thank you!**
- Contact information:

Catherine Dovey, CCP, SPHR  
Chief Compensation Officer  
Compensation Works LLC  
206-306-0299  
cdovey@compensationworks.com

Dave Wittenberg  
Principal  
Verax Point Consulting, LLC  
206-419-9656  
dave@veraxpoint.com