Why do public companies use short-term incentives?

A qualitative study of Boliden, Nordea, Johnson & Johnson, Q-Med and Siemens.

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Acknowledgements

We would like to start by thanking our families and friends who supported us during this process and gave us feedback. We would also like to thank all the employees from the companies that took part in the interviews. Furthermore, we want to express gratitude to our supervisor Robert Joachimsson and our seminar group for your thoughts and ideas on our thesis’ design and content.
Abstract

Despite of the financial crisis managers are receiving large financial short-term incentives in form of bonuses. This has been criticized in the media and by governments, shareholders and numerous of studies have been made about financial incentives and whether they work or not and the results vary. What do the companies themselves say about this? Why do they use short-term incentives?

The purpose of this thesis was to find out why companies choose to have short-term incentive plans which usually consist of an annual bonus. Moreover how the incentive plans are designed and what companies expects from them.

A qualitative method is used in this thesis; five interviews were made in order to collect empirical material. The companies that participated in the study were Q-Med, Boliden, Johnson & Johnson, Nordea, and Siemens. The personnel who were interviewed were Human Resources (HR) directors or Financial Directors or had compensations and benefits as their main responsibility. All companies who participated in the interviews are public companies, although not all of them are listed at the Swedish Stock Exchange, Siemens and Johnson & Johnson are listed at the New York and Frankfurt Stock Exchange.

The conclusion of this study is that companies use short-term incentives as a motivator for the management and to structure goals and set a common aim for the companies’ divisions. They also consider themselves to need them in order to attract and keep good managers. The incentive programme is structured with the aim to increase the company’s profit by motivating employees but also to rate and evaluate the manager. When the incentive programme is well designed and fulfils its purpose it will benefit the shareholders, who owns the company, as profits will increase.
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Important Concepts

Short-term financial incentive programme

A short-term incentive programme is used to reward employee performance. An example of a short-term incentive is an annual cash bonus.

Long-term financial incentive programme

To add as a supplement programme and discourage too much short-term thinking is a long-term incentive programme used to increase overall employee performance. Often used to increase retention, reduce employee turnover, boost loyalty and drive performance. Examples of long-term programmes are stocks and stock options which can only be exercised after some years. (Bång et al, 2009, p. 4)

Economic Value Added (EVA)

Economic Value Added or EVA is an estimate of economic profit. EVA is measured as Net Operating Profit after Tax (NOPAT) less the cost of capital.

\[
\text{EVA} = \text{NOPAT} - (\text{Capital} \times \text{Cost of capital})
\]

Earnings before Interests and Taxes (EBIT)

Earnings before Interest and Taxes (EBIT) or operating income is a measure of a firm's profitability that excludes interest and income tax.

\[
\text{EBIT} = \text{Revenue} - \text{Operating Expenses}
\]
Return On Assets (ROA)

The Return on Assets (ROA) percentage shows how profitable a company's assets are in generating revenue.

\[ \text{ROA} = \frac{\text{Net Income}}{\text{Total Assets}} \]

Return on Capital Employed (ROCE)

Return on Capital Employed (ROCE) measures the returns that a company realizes from its capital investments.

\[ \text{ROCE} = \frac{\text{EBIT}}{\text{Total Assets} - \text{Current Liabilities}} \]

Return on Equity (ROE)

Return on Equity (ROE) measures a firm's efficiency at generating profits from every unit of shareholders' equity.

\[ \text{ROE} = \frac{\text{Net Income}}{\text{Shareholder Equity}} \]

Total Share of Return (TSR)

Total Share of Return (TSR) shows the total shareholder return. It combines share price increase and dividends paid in order to show the total return to the shareholder.

\[ \text{TSR} = \frac{(\text{Price}_{\text{end}} - \text{Price}_{\text{begin}} + \text{Dividends})}{\text{Price}_{\text{begin}}} \]

(Palepu et al, 2007)
1. Introduction

The first chapter begins with an introduction of the chosen subject and it puts the subject in a larger perspective as it explains how short-term incentive programmes have become a controversial topic. The problem discussion explains why financial short-term incentives are important to study further.

1.1 Background

Companies around the world have been criticized in the media and by governments for their incentive bonus programmes; they have been accused of being too generous. CEOs and board members have been given large bonuses as a reward for their jobs. This has become a very controversial topic recently especially during the financial crisis. Governments have accused managements of large companies to be greedy and refusing them financial aid on the basis of giving too large bonuses. The U.S government required that companies who accepted financial aid from them would have to cut back on the CEOs financial compensation. (BBC News, 2009).

Large bonuses to the management are considered unfair especially in time of crisis, but have also been criticized when the economy is prosperous. Much research has been made about using financial incentives as a motivator for employees. The results of these researches vary, some say that it is the best way to get loyal employees and a good way to motivate the management and therefore are bonuses good for the company. (Newsmill, 2009) Whereas, others say that financial incentive plans do not motivate and are therefore bad for both the employees and the company. (Kohn, 1993: passim)

Although, bonuses have been heavily criticized recently, they are still frequently used. The study in this thesis shows why public companies choose to use financial short-term incentive plans and how they are structured.

In Swedish media, bonuses to managements in public companies have been criticized not only by the government but also by shareholders. For example, many of the large Swedish banks received criticism for their high bonuses which has lead to discussions in media about the need for increasing legislation regarding bonuses. (Veckans Affärer, 2010) In an online survey by the Swedish association for private investors “Aktiespararna”, 78.7 percent thought
that paid compensations to CEOs in companies registered on the Swedish stock market are excessive and unfair. (Aktiespararnas’ website, 2009)

In spite of the criticism against financial incentives to the management they are still used as a motivator for the management in public companies. Almost every Swedish stock company in the large cap segment uses some form of financial motivation for their employees in a managerial position (Svt website, 2009)

1.2 Problem discussion

The Swedish government has suggested prohibiting bonuses in government owned companies and the Swedish Financial Supervisory Authority\(^1\) has increased the regulation regarding bonuses in public banks. They are suggesting that rules will be retroactively applied for bonuses that are paid for year 2009. (E24, 2009)

This suggestion has been criticized as there are those who believe that banks need bonuses, in order to encourage risk taking as this is important in the financial sector, in order for the company to perform well financially. This has been claimed about all public companies, thus managements may be more risk averse than shareholders as they bear more risk. The managers may risk losing their jobs if they make bad decisions which lead to losses for the company. However, the shareholders benefit from risks that may cause an increase in the share’s value, and as they can diversify the risk of losing money, they are more positive towards financial risks. (Newsmill, 2009) If the management is not encouraged to take risks, this may be a problem for the shareholders as it may decrease the company’s profit.

Regardless of the criticism against financial incentives, they are still used in many companies as a motivator for the management. We wanted to find out the philosophy behind the company’s short-term incentive plan and how they are structured. This thesis will only focus on financial short-term incentives. We found this to be an interesting subject to study as they have been criticized in media recently by governments and shareholders.

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\(^1\) Finansinspektionen
1.3 Purpose

The purpose of this study is to show why companies choose to have financial short-term incentive programmes, and how they expect that the company and its shareholders will benefit from the incentive plan. Furthermore, our study will find what factors are taken into consideration when the short-term incentive programmes are structured and how the company will benefit from it. This thesis answers the following questions:

- Why do public companies choose to have short-term incentive programmes?
- How is the short-term incentive programme designed and how does it benefit the company and the shareholders?
2. Outline of theories

This chapter presents previous scientific research about short-term incentive programmes and how financial incentives motivate employees. Then follows a section on how a short term financial incentive programme should be structured to maximize its effect. The chapter is concluded with a summary of the outlined theories. This summary is from the authors’ point of view and the models used in the summary were developed by them.

2.1 Background to the theory

Short-term financial incentives can also be referred to as flexible bonuses as this is usually what they are. The flexible bonus is a share of the executives’ salary and usually a maximum percentage is decided. Moreover, bonuses are often linked to performance, how performance is measured varies between companies. Short-term incentive programmes measures performance based on objective criteria such as increased value of the company’s financial ratios. Subjective criteria are also sometimes used by the board of directors to evaluate the executives’ performance. (Bång et al, p. 3-4) The main part of the research used in this thesis were conducted in the US or the UK, although the authors found these studies to be compatible with the Swedish public companies, even though they are aware that there are differences in culture and legislation etc, between countries.

2.2 The principal–agent theory

There is a well known theory called the principal-agent theory that suggests that when a principal hires an agent to perform a job for him there will be conflicts of interests. The principal would prefer if the agent represented his best interest, but the agent puts his own interests first. The principal wants to monitor the agent so he can control him in order to make sure that he acts in the principal’s best interest. This will lead to an agency cost for the principal, because it will cost to monitor the agent. (Jensen and Meckling, 1976 p. 308-310)

This theory can be applied to the relationship between shareholders of a public owned company and the management in that company. Where the shareholders represent the principal and the management the agent, as the management is hired to run the company for the owners (shareholders). In this case the board of directors, legislation and the auditor etc are examples of instruments to monitor the management. (Ibid.)
According to the agent theory managers are risks averse and may hesitate to take risks regarding the business. The manager may need incentives to take risks that may be good for the company. Different types of financial incentives can be viewed as a way to encourage the manager to put shareholders interest before his own, especially if the financial incentive is related to shareholders wealth. (Fama, 1980 p. 289-291) Shareholders themselves do not have the knowledge to predict which investment opportunity will maximize their wealth. That is why they have to trust the manager to make the right decisions. (Jensen and Murphy, 1989 p. 23-26)

2.3 Performance based compensation and agent theory

The top executive in the company, the CEO, has the main managerial responsibility in the management and therefore bears the largest risk. According to the agent theory he will have his private gain in mind before the shareholders wealth. By tying a part of his salary to his performance he will have an incentive to make decisions that benefit shareholders as their interest will be united. Shareholders primarily want wealth by increased value of the stock, according to the agent theory. (McKnight, 1996 p. 558-560)

The CEO is also the one that will bear the largest risk if he makes an investment decision that decreases the company's value. He risks losing his job if the investment ends badly, for the shareholders the risk is smaller as they can diversify the risk by owning a small share of stocks in many different companies. However if the CEO is rewarded for taking a risk by a performance based financial incentive that is tied to shareholders' wealth, he will have an incentive to take more risks. (Bång et al, 2009 p. 5-7)

Another argument in favor of financial incentives based on performance is that managers of all levels in the company will feel a pressure from the outside labour market to be rewarded by their performance. When the labour market is very competitive companies will be on constant lookout for new managers, and when companies do not reward managers based on performance, the best ones will move on to other employments. (Fama, 1980 p. 289-292)

The company does not benefit from losing employees especially not managers as they may take with them valuable information and knowledge about the company, they may also have been given education and training from the company which if they resign will be a loss. (Bång et al, 2009 p. 5-7)
A statistical study conducted in the UK by Philip. J. McKnight in his article “An explanation of top executive pay: a UK study” found evidence that bonuses are affected by the share’s value. This study used 200 randomly chosen public companies’ annual reports to study the connection between different factors of companies’ economic performance and top executives’ total pay. The factors of the companies economic performance was earnings per share, change in operating profits, change in sales, change in shareholders’ value, total pay to executives was fixed salaries and flexible bonuses. According to this study a statistical connection could be found between flexible bonuses and earnings per share. None of the other variables of the companies’ economic performance could be linked to the increase in executives’ bonuses. A conclusion could be made that bonus are linked to the earnings per share, as the fixed salaries did not seem to be affected by the change in earnings per share. (McKnight, 1996, p. 562-565)

2.4 Contradictions to the agent theory

Stathopoulos et al found patterns that disagree with the predictions of the agent theory. One study showed that executives that had only mid-performing results received higher flexible pay than the high-performing executives, although they produced a smaller increase of the shareholders’ wealth. Another study about the pay packages of poorly performing executives reveals an increase in their exposure to risk as well as the value of the equity-based compensation they receive. The author suggests that this pattern disagrees with the agent theory as agents chose to avoid risk taking in high-risk corporate environments even though they are compensated for it. (Stathopoulos et al, 2005, p. 104)

2.5 Why Incentive plans cannot work

“This section draws heavily on Alfie Kohns’ article: Why incentive plans cannot work”

There are some researchers that oppose the claim that financial incentive programmes motivate the employees to do a better job. Kohn refers to a number of studies that show how people who expects a reward after doing a job or after having done an exceptional job, does not do it as well as the ones who do not expect a reward at all. Alfie Kohn is one of the researchers that oppose the claim that incentive programmes work, in his article “Why Incentive Plans Cannot Work”, Kohn suggests that the studies which claim that financial incentives work do not consider that the increase in performance is only temporary and the
incentive plan does not create any obligations or actions of value. Kohn describes six different reasons why incentive programmes do not work. (Kohn, 1993 p. 54)

1. Payment is not a motivation. Kohn claims that earlier studies only suggested that people are concerned about their salary but that money comes in fifth or sixth place of what they find most important with their jobs. He says that too little money can annoy people, however, that does not mean that more and more money will increase the satisfaction and the motivation among the employees. (Kohn, 1993 p. 58)

2. Rewards punish. When coercion and fear destroy motivation and create rage and defensiveness among people, Kohn finds that punishment and rewards are two sides of the same coin. Do this and you get that is similar to do this or that will happen to you. It can therefore become a punishment for the one who thinks he will receive a reward but does not. (Kohn, 1993 p. 58)

3. Rewards rupture relationships. Kohn says that when the relationships between employees only become temporary in order to obtain a personal reward they do not create any cooperation which improves the system for everyone. Kohn says”Without teamwork, in other words, there can be no quality”. Many are also going to feel like they have lost in the competition and this feeling can increase if the distinction is published, for example in a newsletter. Due to the competitions people are afraid to ask for help with things they do not know so they do them alone and receive bad results. (Kohn, 1993 p. 58)

4. Rewards ignore reasons. To solve a problem the manager must understand what the cause of the problem is. But if the incentive plan’s purpose only is to increase productivity it is hard to see the underlying problem to make meaningful changes. Rewards are an easier way for the manager to get the employees to do a good job, than simply treating his employees well. (Kohn 1993, p. 59)

5. Rewards discourage risk-taking. Kohn maintains that the employee is less willing to take risks due to the reward and instead only does what is necessary to get the reward. Studies have shown that an employee that works for a reward tries to reduce risks and choose tasks that is simpler to do so that the chance to get paid increases. The employees are then only motivated to get the reward. (Kohn, 1993 p. 62)
6. **Rewards undermine interest.** Kohn says that a person that does a good job, does it regardless of the monetary compensation, because he loves what he is doing. Rewards can then have an opposite effect, the more a manager stresses his employees with what they can earn for performing well the less interested will they be in their jobs. It then becomes the reward that drives the work and the employees lose interest in what they are doing. (Kohn, 1993 p. 62)

Some other disadvantages and problems with incentive programmes are suggested by Joakim Bång and Daniel Waldenström about in their report “Rörlig ersättning till vd – vad säger forskningen?” The first disadvantage they discuss is the agent problem that might appear when the board of directors decides the salaries for the management, as they may not act in the shareholders’ best interests. The board might approve the manager’s suggestion for salaries instead of discussing reasonable ones. Furthermore the board might be biased because of the loyalty that exists between the managers and the board, they may not want to argue with the managers about the compensation package. If the board would approve an unreasonably high salary then it would be easy for them to hide behind hard foreseeable incentive programmes and a less detailed annual report. (Bång et al, 2009 p. 8)

Bång and Waldenstöm also discuss the difficulty to measure the managers’ performance. The board is forced to use indirect results like the stock price and accounting information. One problem with these measurements is that the results can easy be manipulated to a specific date so that the manager can get a higher salary. Another problem is all the other factors that affect the results but have nothing to do with the manager’s performance for examples change in exchange rate and changes in oil price. (Bång et al, 2009 p. 9)

The last problem with incentive programmes according to Bång and Waldenström is the form of the organization’s culture, which is a very important matter for the management. The incentive programmes can get the participant to consider the situation in an economic rather than in a social perspective there the reciprocity and trust can get lost between the management and the employee. There is a risk that the intrinsic forces that motivate people to do well; a sense of duty, prestige, and trust not going to be achieved as they are not rewarded. (Bång et al, 2009 p. 10)
2.6 How to design a successful short-term incentive programme

“This section draws heavily on Edward, E, Lawler’s book: ”Pay and organizational development” 1981, pages 88-100”

As mentioned earlier in this thesis, companies are different from one another and therefore should and are incentive programmes different from each other, though there are factors that all companies should consider when designing and implementing a new short-term financial incentive programme. The short-term incentive programme is usually a bonus that is somehow performance based and a percentage of the fixed salary. It is important that companies choose a performance based system that is effective and suits its purpose. If the system is poorly designed and unfit for the company it can be very costly and result in few benefits for the company. To avoid this, companies should consider four factors when designing and implementing a new performance based system, which are:

**Important rewards should be given.** It is important that the reward results in a noticeable change in the pay for the employee, and that of course is a subjective amount. However as a rule of thumb the bonus should be at least 3 percent of the employee’s monthly salary. But this of course varies with the employees work and responsibility. The employee needs to feel that he has the potential to change his pay and that the change is noticeable. (Ibid, p. 88)

**Performance can be realistically and generally measured.** Choosing the right criterion or criteria is crucial to make the incentive plan successful. There are no criterion that are generally better than others, which one is the best is determined by the situation. However the designer of the incentive plan will face a tradeoff between using objective or subjective goals to measure performance. Both subjective and objective goals have their advantages and disadvantages. Subjective goals (sometimes called individual goals) are easier for the individual to affect but may be hard to measure and there is a risk that the employee might feel he is not being fairly judged. However, the objective goals as financial ratios were performance is linked directly with profits may be difficult for the employee to influence. Though they are easier for the management to measure and it is easier for the manager to be impartial in his valuation of the performance. (Ibid, p. 89-91)

**Information can be provided that makes clear how rewards are given.** It is important that the employee and the manager have agreed on which goals that should be reached in order for
the employee to receive the bonus. Whether the criteria are subjective or objective the employee should be clear on how to fulfill them. (Ibid. p. 97-100)

**Trust is high and employees accept the performance based system.** If employees do not accept the system they will not try to receive the reward. If trust is not mutual, employees may try to present false information in order to receive the reward. There must also be mutual trust between the employee and the manager as the employee must feel that he is fairly judged and his efforts are noticed. (Ibid. p. 97-100)

It is also important that the participants in the incentive plan take part in its design. Previous studies show that if the employees that are affected by the incentive plans get to influence the design of it, it will be more effective. This may partly depend on people’s reluctance towards change, if they themselves get to influence what is going to change and how it changes may be easier to adapt. (Lawler, 1981 p. 105-106)

Due to the financial crisis bonuses have been criticized in the media lately, Harvard Business Review published an article that suggests ways to avoid residual costs and agitated shareholders. In order to design a successful incentive plan one must understand the company’s strategy and let the incentive programme reflect the strategy. The board or the CEO, whoever is in charge of the incentive plan, should conduct an annual performance evaluation of the participants in the incentive plan. The board of directors should evaluate the CEO and his compensation, if a consultant firm is used it should be chosen by the board of directors because the board must be certain that the evaluation is unbiased. The incentive plan should also be discussed with the large investors and their input should be considered in order to avoid being criticized in the media which could be very harmful for a public company. (Harvard Business Review, September 2009)

### 2.7 Summary of theories

The main focus of the theory has been on the agent theory and its contradictions, however, a more psychological angle of why incentive plans do not motivate has also been presented. The advantages with a successful incentive plan has been summarized into two models, one that explains why companies benefits from short-term incentive plans and one model that explains how a successful incentive plan benefits the company and the shareholders.
### 2.7.1 Advantages with a short-term incentive plan

All companies need to attract personnel and everybody wants the best and hardest working ones, on a competitive labour market the company will need something to attract workers. The short-term incentive plan is important for managers and therefore it will be a good way to attract personnel. The company will also need to keep managers as it is expensive to lose them especially considering that they may have gained valuable information about the company. The company may also have given an executive expensive training and educations that will be a loss if an executive decides to leave the company.

In order to keep executives hard working and make sure that the decisions and investments that are made are for the company’s and shareholders best, the executives will need an incentive. Linking the profit and value of the company with the executive’s salary is a way to make sure that the executive will have the interests of shareholders in mind. Since the CEO

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*Model 1: Advantages with a short-term incentive plan*
who is the top executive has the main responsibility of the business, bears the main risk, he may be risk averse. However, if he is rewarded for taking risks if the outcome is good, he will have an incentive to be more risk taking.

2.7.2 How a well designed bonus plan is good for the shareholders

The main thing seems to be to keep in mind that the bonus plan should be linked to performance and that the goals are clear. When the short-term financial system is well designed and have its desired effect it will gain the company hence also the shareholders. However, if the incentive plan is badly designed and unfit for its purpose or the company’s strategy it will have little or no effect and it will only be costly for the company.

Credibility is important for a public company and discussing the short-term incentive programme with the shareholders or at least the main investors might be a way of keeping the credibility. It is important that the shareholders approve of the short-term incentive plan and that they recognize that they can profit from it. The model below explains the relation between a well designed short-term incentive programme and how the shareholders benefit from it.
Short-term incentive plans and shareholders wealth

When the company performs well both the executives and the shareholders will gain because their wealth is increased.

The company has a bonus plan where performance is measured by financial ratios that measure the company’s profit.

When the executive reaches his goals he will receive a reward. This is also an incentive to stay with the company.

The executive has clear goals to follow and these goals will increase the profit hence have shareholders interests in mind.

Model 2: Short-term incentive plans and shareholders’ wealth
3. Methodology

This chapter describes the methods used in order to perform the study. The chapter begins with a description of the approach to the study. The two following sections present the methods that were used in order to collect data. Then follows a description of how the questions for the interviews are related to the outlined theories.

3.1 Approach

The study in this thesis has been conducted with a deductive approach in order to investigate how and why companies use short-term incentive programmes. Incentive programmes of all sorts have been a popular topic within both psychological and economic research. The intent was to give a new angle to this research therefore a deductive approach was chosen in order to let the companies give their own reasons to why they use incentive programmes. Since the purpose of the study required the information from the company that is not disclosed in the annual report or any other formal report, the authors decided upon a qualitative method. The benefit of using a qualitative method for this thesis was that the authors were able to receive first hand information from personnel working at the company with short-term incentive programmes. Furthermore, an advantage with using a qualitative method in form of interviews is that the interviewers have the chance to ask open questions and ask spontaneous follow up questions when needed.

3.2 Collected primary data

The authors chose to use a qualitative method for this thesis; hence the empirical material was gathered through interviews. Companies that have an office in Uppsala and the Stockholm area were contacted by either mail or phone. The first five companies that responded to the authors request were interviewed. The request were sent to companies listed at a Stock Exchange, as the authors wanted public companies, random public companies within the Uppsala and Stockholm area were chosen. Two banks were contacted because the authors wanted to interview a bank as Swedish banks have been criticized in media regarding the use of short-term financial incentives. Ten public companies were contacted and five of them agreed to participate in the thesis.
The authors decided that five companies would be enough for the study. The initial aim was to have an interview with an audit firm that offer advisory regarding incentive programmes. To two large Audit firms, KPMG and Deloitte, were contacted, although neither of them were able to be of any assistant, as they do not offer advisory regarding short-term incentives, only for the long-term financial incentive programmes. According to Deloitte the companies structure their own short-term financial incentive programmes without any help from consultant firms.

The companies were contacted, first by e-mail and then by phone, the authors described the purpose of the study and then asked to speak to someone who could answer their questions. The companies were given the possibility to choose the one at their company that they thought was the best candidate to give an interview regarding their short-term incentive programme. This turned out to be either the HR director or the financial director.

The people who were interviewed were Leif Bernsmed from Johnson & Johnson, Henrik Östberg from Boliden, Alexander Kotsinas from Q-Med, Peter Karlsson from Nordea, Kurt-Ove Åhs and Maria Bygdeson from Siemens AB.

The interviews took place at the companies and the interviewees were asked open questions and follow up questions were asked where it was suitable. The authors believed open questions to be the best option since they wanted the interviewee to answer freely. They tried to avoid asking leading questions that would give a predictable answer.

The interviewed personnel who wanted the questions in advance got those by e-mail a couple of days before the interview. Some of the interviews were recorded, with approval from the ones being interviewed. The authors experienced some technical problems with the recorder and therefore were they not able to record all the interviews.

We sent the version of the thesis that were presented at the final seminar to the interviewees, and gave them the opportunity to suggest changes of the empirical material.

3.3 Collected secondary data

In the empirical chapter secondary information were used such as the companies’ annual reports to complement the interviews. In the chapter of outlined theories were secondary information used as a source. Information was gathered through searching in the database
Business Source premier and in Uppsala University’s database: DISA-library. The key words that were used when articles were searched for were “agent theory” and” financial incentive programmes”, “CEO bonus”, “design of incentive programmes”. The aim was to use articles from different researchers with different points of view to get both the advantages and the disadvantages with incentive programmes, the purpose was to present an impartial theory that discuss both advantages and disadvantages with incentive programmes.

3.4 Operationalization

The agent theory was used to explain why companies use short-term incentive plans. The agent theory presents argument to why financial short-term incentives are important and how they can be good for the shareholders. Those arguments have been a benchmark for the questionnaire. The arguments against the agent theory and disadvantages with short-term incentive plans presented in the outlined theories, was not directly used as background for the questions. Instead, an open question to the personnel from the companies was asked, that let them find disadvantages with their own programme or short-term incentives in general. This was formulated as an open question in order to not influence the interviewees’ answers.

To find the answer to why companies choose to have financial short-term incentive programmes and what they expect from them the authors asked the interviewees how their programme is structured and which criteria performance is measured by. These questions were linked to the first model in the summary that provides arguments to why companies need to use incentive programmes. Section 2.6 “How to design a successful incentive programme” argues how an incentive programme should be designed and which criteria that should be used when measuring performance in the incentive programme. Considering this section, the authors found it important to find out how performance is measured in order to find the aim of the companies’ incentive programmes.

The authors also asked if the programme has been evaluated and how they think that the shareholders benefit from the incentive programme. Furthermore, the interviewees were asked how long they have had their incentive plan. This question was asked in order to find out if the short-term incentive plans had been subject to change, in that case why the incentive plan had been changed.
The interviewees were also asked if they could find advantages with their own short-term incentive plan. For these questions was the first model in the summary of the theories taken into consideration, but the authors wanted open questions. The second model in the summary of the outlined theories was also used as a background for the question about how the company and the shareholders benefit from the short-term incentive plan. The interviewed personnel were asked to describe how they thought their incentive plan would benefit their companies’ shareholders. No reference to the model during the interview because were made, as this could lead the interviewees’ answers.

To find out what factors the management takes into consideration when they design their bonus incentive programmes, the interviewees were asked who designed the programme and what they think is the success of their programme. They were also asked if the management took part in the design and if it was discussed with the shareholders. These questions are connected to section 2.7.2 and the model in that section that describes how shareholders benefit from a well designed short-term incentive programme. Furthermore, section 2.6 “How do design a successful short-term incentive programme” was used to formulate the questions to the interviewees. It is claimed in section 2.6 that employees who are affected by the short-term incentive plan should be able to influence its structure. Furthermore, it is suggested that the incentive plan should be discussed with the main investors. This was taken into consideration the interviewees were asked if the management at their company took part in the design of their short-term incentive plan and if they had discussed it with their shareholders. Moreover, the authors asked the interviewed personnel if they believe trust to be an important factor in the success of their short-term incentive plan, or if they believed other factors to be important for their short-term incentive plan. This question was based on the claim from Lawler (1981) that trust is important between managers and their subordinates in order for the incentive plan to be successful.

3.5 Trustworthiness of the study

The empirical part and the results in this thesis are based on the interviews with the employees, who were best qualified at the companies to answer our questions. This information has been received from employees that have knowledge and experience about the subject and that take part in the companies’ incentive programmes. The companies themselves chose the personnel that they thought were able to answer the questions regarding short-term
incentive programmes this could have been a disadvantage for the study as the right person might not have been interviewed, and however, the authors do not believe this to be the case. Some answers are not easy to measure although the authors find them useful as it is interesting to know the employees own thoughts on the programmes as they are a part of them themselves. However we know that the interviewed personnel might be biased since they may have been involved in the design of the incentive plan.

3.6 Critique of sources

We are aware of the risk that the interviewed personnel who work at the company may not tell the whole truth as they may be worried to hurt the company’s reputation. The main part of the theory is from articles written by researchers and has been found in Business Source Premier. We consider the articles we found as relevant and useful material, our aim was to find articles that discussed the topic from different point of views. We also used the book "Pay and Organization Development" by Edward. E Lawler, he uses research from various companies in the U.S as a source for this book. Edward E Lawler is a Professor in Organizational behaviour and has a PhD in Physiology hence he has a great range of experience within this subject. We believe this book to be a reliable and relevant source even though we recognise that no research is completely objective.
4. Empirical Material

This chapter presents the empirical material collected from interviews. It begins with a presentation of the interviewed companies. The answers from the interviews are discussed together under five headlines.

4.1 A presentation of the companies that participated in the study

Boliden

Boliden is a metal company that is listed at the Stockholm Stock Exchange (Large Cap) and has an annual turnover that amounts to approximately SEK 30 billion. Boliden is operating in Sweden, Finland, Ireland and Norway and has its head office in Stockholm. (Boliden website, 2009)

Johnson & Johnson Nordic (J&J)

J&J is a healthcare company and the Nordic head office is located in Sollentuna. J&J is a part of the Johnson & Johnson group and is listed at the New York Stock Exchange. The company is operating in Sweden, Denmark, Norway, Finland, and Iceland and in the Baltic States. J&J has its main office in New Jersey, United States of America. J&J had a turnover that amounts of approximately SEK 1.6 billion, in year 2008. (J&J website, 2009)

Nordea

Nordea is a bank and has its Swedish head office in Stockholm, Nordea is listed at the Stockholm Stock Exchange (Large Cap), Helsinki Stock Exchange and Copenhagen Stock Exchange and had a turnover that amounts of 8.2 billion Euro year 2008. (Nordea website, 2009)

Q-Med

Q-Med is a medical technical company that is operating in 20 countries and the head office is located in Uppsala. The company is listed at the Stockholm Stock Exchange (Mid Cap) and had an annual turnover that amounts of SEK 1.272 billion. (Q-Med website, 2009)
Siemens Sweden (Siemens)

Siemens is an electronic company that is a part of the Siemens group and is listed at the Frankfurt Stock Exchange and New York Stock Exchange. Siemens AG has its main office in Munich Germany. The Swedish branch of Siemens has its head office in Upplands Väsby and had an annual turnover that amounts of approximately SEK 18 billion. (Siemens website, 2009)

4.2 Why public companies choose to have short-term incentive programmes

Four out of the five companies interviewed for this study had the same answer to this question. They claimed that it was necessary to have a short-term incentive plan in order to keep good and hard working personnel. Not only to keep the employees in the management hard working but to be competitive in the labour market. In addition using money as a motivator was also a strong motive for the companies in question. The interviewee from Q-Med had different answers to this question, than the others, this was mainly due to the fact that they have a different system. They have a profit sharing programme that all employees at the company participate in. Every year the profit is measured and if it exceeds the budget everybody in the company gets a piece of the profit. The top executives at Q-Med get a higher share of the profit than the rest of the employees. The criteria that are used in order to measure performance are earnings before interests and taxes (EBIT) and operating profit if both of these financial ratios exceed the budget the management will get 30 percent of their annual salary. The CEO of Q-Med decided not to have any incentive programme at all since this had been a problem for Q-Med in the past. The advantage with this system suggested during the interview, is that it is democratic as everybody get a fair share of the profit in good times. Although is Alexander Kotsinas, CFO of Q-Med not satisfied with the system as he does not believe it to be motivating as it is not aggressive and differentiated enough. Furthermore, Kotsinas believes the individual has little or no impact on the outcome of the profit. (Kotsinas, 2009)

The other four companies that participated in our study used only an annual bonus as a short-term incentive. The performance in these incentive plans are measured by both objective and subjective measurements. Åhs and Byggdeson at Siemens thought that the benefits with having an annual bonus is that it is a good motivator that makes people work harder and at a competitive company as Siemens it is important to motivate the staff to reach their high goals.
Henrik Östberg at Boliden proclaimed that competitive salaries to the management are crucial for a large public company as Boliden in order to attract and keep the best personnel. If Boliden for some reason would offer flexible bonuses to their managers they would have to compensate with high flexible salaries. Bonuses based on personal performance and the company’s financial performance are better to use in order to attract personnel, than high fixed salaries, as the bonus will be nil when profit is nil. However, if Boliden would have had high fixed salaries instead of flexible bonuses they would have had higher costs in form of salaries in 2008 when profit was poor. (Östberg, 2009) Moreover, Bernsmed at J&J stated that if the company were to remove the bonus for some reason they would have to compensate by raising the fixed salaries to avoid losing personnel.

Peter Karlsson at Nordea claimed that short-term and long term incentives are important for a large bank as Nordea, since they need to attract and keep the best candidates in the business. It is also important at Nordea to measure performance even if it is not a basis for variable pay and that is why Nordea uses a balanced scorecard. (Karlsson, 2009)

4.3 How performance is measured in the short-term incentive plan

Which criteria companies use to measure performance differs to some extent and so does the structure of the short-term incentive plans. As already mentioned Q-Med has a profit sharing system which is not an actual bonus plan. This makes it hard to compare with the other companies’ incentive plans. The other four companies use annual bonuses which are measured by both individual and objective measurements such as financial ratios. The individual goals are discussed and decided together with either the colleague or the executive above, and new individual targets are made each year.

The objective targets are financial and accounting ratios as Economic Value Added (EVA), Return on Equity (ROE), Return on Capital Employed (ROCE), and Earnings before Interests and Taxes (EBIT). The objective goals change every year, and depend on which strategy the company takes for the year. In addition, the ratio that performance is measured by varies from each year.

The interviewed personnel were unanimous when proclaiming that it is important to choose the criteria and right targets to work for. If the targets are wrong the incentive plan will not
work, and thus, both the individual and objective targets need to be adequate and the employee must have an impact on the outcome.

Customer satisfaction is an important factor when evaluating the top management’s performance. An unbiased research conducted by an independent company is used by Nordea, in order to decide how the top management has reached the criteria of customer satisfaction. The CEO is also evaluated by how satisfied the personnel at Nordea are working at the company. Furthermore, the CEO of Nordea is evaluated by the budget as well, where he is expected to keep earnings up and costs down. Total shareholder return (TSR) is also used as a criterion in Nordea’s Long-term Incentive programme in order to connect the shareholders interests with the managements. (Karlsson, 2009)

At Siemens they re-designed their short-term incentive plan in order to make it more relevant and easier for the employee to influence. They used to have only financial ratios as criteria but now they measure 60 percent of the bonus by financial ratios and 40 percent by individual goals. These goals and ratios are decided in the beginning of each year in a discussion with their supervisor. The ratio that will be measured each year depends on which project the manager is working on and the company’s strategy for that year. The bonus is also dependent on how well the manager follows national rules and regulation and these goals are determined by the management in the main office. (Åhs and Byggdeson, 2009)

At Boliden performance is measured at 25-50 percent by financial goals such as ROE, ROCE or EBIT and the rest of the bonus are dependent on individual goals. The individual is only measured by the financial goals which he can affect. The manager is also expected to present the development of costs that benefits the financial development of the company; these costs are only the ones that he can affect. Which financial goal that is important for the manager is dependent on the division he is managing, it is important that the goal is right and that the manager can affect and control its outcome. The goals at Boliden vary from year to year as they do for Siemens, Nordea and Johnson & Johnson. At Boliden nobody will receive a bonus if one of the divisions is performing badly and this result in the company not exceeding the breakeven point. (Östberg, 2009)

Johnson & Johnson (henceforth J&J) is an American based corporation, and their Swedish branch is in many aspects controlled by the main office in the United States. The short-term
incentive plan is one of those aspects, the incentive programme is designed by the top executives in the U.S and the same plan is used in Sweden as in the U.S. At J&J a performance contract is used as a basis for deciding the bonus, where the budget is a foundation and performance is rated by a scale from 1-10. What goals that will be used is discussed annually and decided at the Swedish branch, and they depend on ongoing projects. The three top executive of the financial, logistics and HR divisions have the same incentive plan, however, the managers of the sales division have an incentive plan that is based more on sales figures. Nevertheless all administrative personnel are affected by the short-term incentive plan. (Bernsmed, 2009)

4.4 Disadvantages with the short-term incentive plan

When we asked the interviewed personnel if they could find any disadvantages with their system or with short-term financial incentives in general, they could not find any disadvantages with their own incentive plans. Except for Kotsinas at Q-Med who believed that the profit sharing plan did nothing for his motivation and that it was not effective. However, he said that it is a democratic system that gains everybody working at the company. Nevertheless, Kotsinas claimed that it is too hard for the individual to affect the outcome as their daily job does not influence the profit. (Kotsinas, 2009)

Henrik Östberg at Boliden thought that a disadvantage with short-term incentive programme in general is that top executives may experience difficulties to affect the outcome that is measured. In addition he claimed that it is very important for the individual that he can affect the variable that is measured and that individual goals are included. This same argument was maintained by the representatives from both Siemens and J&J.

Åhs at Siemens also claimed that a disadvantage with short-term incentives in general could be that people are driven too hard and that the business is driven the wrong way if the wrong financial goals are used. (Åhs, 2009)

Both Östberg (Boliden) and Bernsmed (J&J) maintained that a disadvantage with short-term financial incentive plans may be that they encourage short sight thinking, and therefore it is important to have a long- term financial incentive programme as well, where long term goals are considered in order to receive compensation. (Östberg, 2009) (Bernsmed, 2009)
4.5 How the short-term incentive plans are structured and by whom

We asked the interview personnel how long they have had the short-term financial incentive programme and if they only consisted of a performance based bonus and how it is structured. All of the interviewees answered that their company have had their incentive plan for a long period of time. Karlsson at Nordea said that the management at Nordea has had a variable salary plan for several years and Åhs at Siemens stated the same about the management at Siemens. Kotsinas at Q-med said that the profit sharing system they have, has been used at least 10 years. Bernsmed at J&J said that they have had their bonus plan for at least 15-20 years, changes may have occurred in the incentive plan, although, not to Bernsmed’s knowledge as he has only worked at J&J for a year. Furthermore all the interviewed personnel answered that the short-term financial incentive programme consists solely of an annual flexible financial incentive.

At J&J, the short-term incentive plan is developed and designed in the U.S by the top management; Bernsmed did not know exactly how this process was carried out. The top executives in the Swedish branch did not get to influence the design of the short-term incentive plan, other than the annual discussion of setting goals.

At Boliden the design of the incentive plan is a discussion between the CEO and the HR director. While at Nordea, the guidelines for the short-term incentive programme are decided at the shareholders’ meeting. Most Swedish companies have a committee\(^2\) in the board that is responsible of deciding the size and criteria for compensations to the management, however, the CEO and sometimes the HR director structure the incentive plan and then give a proposition to the committee and then the board members vote for a decision. (Östberg, 2009) (Karlsson, 2009)

At Siemens which has its main office in Munich, and is listed on both the Frankfurt stock exchange and the New York stock exchange, the rules are different from the Swedish public companies. At Siemens’ Swedish branch, the managers were not able to influence in the process of the design of the short-term incentive programme. Although, the Swedish CEO were invited for a discussion when the system were discussed in the whole corporation.

\(^2\) Ersättningskommitté
However, the process of setting annual goals for each manager in the Swedish branch, were decided by the management at Siemens Sweden. (Åhs and Byggdeson 2009)

4.6 How the short-term incentive plans benefits the company and its shareholders

When the interviewed personnel what the shareholders gained from the incentive plan, all of them except from Q-Med answered that a well designed incentive plan with the right goals will motivate the participants to work harder and that will increase the profit.

At Nordea is the total shareholder return used as a criterion for the participants in the long-term incentive programme, because then will interests be linked. (Karlsson, 2009) The same philosophy was expressed at the interviews at the other companies even though various financial ratios are used to measure performance. Hence the profit will increase if the employees work harder and this will please the shareholders as they benefit from increased profits.

At Nordea the bonus for the top management has been cancelled for 2009, this was a voluntary decision made by the management themselves. The government participated in Nordea’s new share issue this year, and then the government demanded that five persons within the management would refrain from the annual bonus in 2009. This also caused the top management to voluntarily refrain from bonus disbursements in 2009, even though goals were partly reached for 2008. Karlsson did not think that this would have a negative impact on the managements performance as they did it voluntarily, besides performance is still measured at Nordea by a balanced score card.

Karlsson also says that the short-term incentive programme along with the long-term incentive programme has been evaluated at Nordea, and the result was positive. (Karlsson, 2009)

When Nordea’s short-term incentive plan was discussed at the shareholders’ meeting in 2008, the board presented a suggestion of remuneration guidelines and the government (that owns a large share of the stocks) gave an alternative proposal of remuneration guidelines. However, the shareholders voted for the boards’ proposition, this proposition contained the suggestion that the management would refrain from their annual bonus in 2009. (Karlsson, 2009)
At Q-Med and Boliden the short-term incentive plans have never been a question for the shareholders, this is according to the Swedish law a question for the board to decide. Hence, the short-term incentive plan has never been discussed at the Shareholders’ meeting. Nonetheless, both Östberg and Kotsinas maintained that their short-term incentive plan had never been criticized in the media or at a shareholders’ meeting. Moreover, they both claimed that their systems are transparent. Östberg at Boliden claimed that their incentive plan is good for the shareholders as it is an honest plan and there is no room for cheating. (Östberg, 2009)

All the interviewees claimed that they had not experienced problems with managers presenting false information. Nevertheless, they agreed that mutual trust between managers at different levels is an important factor for a successful incentive plan. Åhs at Siemens said that there is no risk of cheating to occur within their incentive plan, because the information is carefully examined and the individual goals are not possible to cheat on. However, he also said that one problem with being individually judged by a colleague is that they both must put their relationship aside in order to be unbiased. At Siemens they only judge performance for one year at the time, this according to Åhs will rule out the risk of friends letting their personal feelings affect their judgment. (Åhs, 2009)

At J&J precautions against cheating and unfair judgments is taken by using subjective individual goals along with the objective goals that are carefully measured. Bernsmed emphasizes that it is important that the managers is correctly and objectively evaluated, hence the manager should not receive a bonus based on his friendship with the CEO. He also stresses that it is important that the incentive plans are experienced as fair among employees. At J&J it is not disclosed how much each manager receives as bonus, as the sum is based on each manager’s performance thus the amount each manager receives vary. When the short-term incentive plan is well designed and successful as Bernsmed claims it is on J&J, it is a good motivator for the employees and therefore good for the company as it increases the profit. (Bernsmed, 2009)

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3 According to “Aktiebolagslagen” the board of directors is responsible for deciding the compensation for the CEO and the management.
5. Analysis

In this chapter we discuss the outlined theory together with the empirical material, using the models from the summary of the theory.

5.1 Why companies choose to use short-term incentive programmes

The interviewees was asked to point out advantages and disadvantages with their short-term incentive plans. The advantages they mentioned were both generic and specific. The disadvantages mentioned by the interviewees were mostly generic. The authors are aware that this may have been a sensitive question for the interviewees as they may be worried to hurt the company’s reputation. Moreover, some the interviewed personnel, had been a part of the design of the incentive plan, and may therefore not be willing to criticize it. The answers the authors received to this question were rather similar to each other. Moreover, to a great extent were the answers similar to the outline theories and the models based on it.

According to the first model in the summary of the theories, the first reason to why companies need short-term incentive programmes is to attract new personnel. This is consistent with the claim that Östberg (Boliden) made, large corporations like Boliden needs to offer competitive salaries in order to keep and attract personnel. Furthermore, he suggested that, when the company is performing badly they may have problems paying a large fixed salary, although if they give their employees performance based bonuses they are not bound to pay them when capital are scarce. Bernsmed at J&J also said that if they were to remove the annual bonus they would have to compensate by increasing the fixed salary, and this would of course lead to an additional cost when profit is poor.

Another advantage also discussed in the agent theory, which was suggested by Åhs at Siemens, was that money motivates managers who have a very demanding job to work harder. The short-term incentive plan pushes them towards strategic goals, and it is clear for everybody were the focus will be, i.e. which financial targets that will be considered or other goals that the business will work towards.

The advantages, suggested by the agent theory for the short-term incentive programmes are different from the answers from the interviews, in the aspect of short-term incentives
encouraging the manager to take more risks. Whatever risk and the level of risk, managers are exposed to vary among businesses and industries and neither of the people we interviewed seem to think of this as an important aspect of incentive programmes. They did, however, mention the benefit of having clear goals to follow and to receive feedback on a regular basis. As the goals for the business are set and a discussion is held that outlines which targets the executive are going to work towards therefore one can assume that the risks are included in the targets. The more specific the goals are in the incentive plan the more confident should the executive feel about taking risks. Arguments from the agent theory suggest that the CEO is the main risk bearer as he has the main responsibility. The answers we got from the interviews were not quite consistent with the theory in this particular aspect as the philosophy behind the CEO’s bonus was not different from the rest of the top executives. In addition, the CEO’s performance was measured by financial ratios and personal goals as the other executives. Hence the conclusion is that clearly outlined targets will decrease the CEO’s reluctance towards risks, as he will receive instructions from the board which goals he should work for.

Furthermore, the agent theory claims that the managers and the shareholders interests will be combined when the bonus is dependent on shareholder wealth. Linking the bonus to financial ratios will be a way to make sure that the manager and the shareholder have the same target. Although in the Swedish public companies the board are not bound by law to present the managements’ compensation to the shareholders for approval. In the U.S, however, this may be more common. If the shareholders do not have influence on the goals and targets that the performance is judged by, one can wonder if they will benefit from them. The targets are worked out and decided by the CEO and sometimes the HR director, and approved by the board, the same stakeholders as according to the agent theory only looks after their own interests. From the perspective presented in the agent theory one can wonder if shareholders should trust the financial incentive plans.

However, shareholders wealth will be increased if the company’s profit increases and the value of the share increases. The purpose of the incentive plans for the management is to increase profit which will benefit the shareholders hence the incentive plan combine interests.
5.2 Disadvantages with short-term incentive programmes

Bång and Waldenström discuss in their article advantages and disadvantages with short-term incentives, as a disadvantage with the incentive programme they suggest that information may be manipulated and there is a risk that the goals are wrong and will drive the business in the wrong direction. This is a weak argument as it is easily avoided by basing the incentive plan on personal subjective goals. Furthermore, the financial information is vigilantly searched through by auditors and before that the CEO (when a manager is being revised) which makes it hard to cheat without being discovered. That is why trust is so important according to Lawler, the manager need to trust that the employee does not present false information in order to receive the bonus. Is also important that the employee trust the executive who he is evaluated by otherwise there is a risk that the employee will feel that there is no chance of getting the reward as he is not fairly judged.

Kohn argues that financial incentives do not work at all, of several reasons, for example he claims that the employee will be more risk averse when there is a reward to be received. The employee will be afraid to take risks if he jeopardises his bonus when the outcome is bad. According to the agent theory, however, risk averse managers will be motivated to take risks when the good performance is awarded. These arguments are two sides of the same coin, which argument is correct depends on if risk taking is encouraged or punished in the incentive plan.

Moreover, Kohn argues that reward punishes because when an employee is expecting a reward but does not receive it he will experience it as a punishment. However, we do not believe that this is the case when annual bonuses are paid to the management as they are would be rated and evaluated even if they would not receive a financial incentive. The management of a large corporation is usually evaluated by their financial success of their divisions and if one of the managers would be considered to perform an inadequate job he would be punished, he might be resigned from his job or replaced within the company. Furthermore, Kohn’s article seems to be best applied on the relationship between workers and their managers.

Bång and Waldenström claims that subjective goals are disregarded in short-term incentive plans, as only the endeavour to reach the financial ratios are awarded. However, as Östberg
and Bernsmed claimed, this is avoided by having a long term financial incentive programme as well as a short-term incentive programme. The long-term incentive plan usually has a longer time period than the short-term incentive plan and therefore is the performance measured by long term goals. The balance between long-term and short-term incentives will decrease the short sighted thinking, says Bernsmed.

Furthermore, Bång and Waldenström argue that managers’ performance is not all that influences the profit. The profit is also affected by factors outside of the company that the managers cannot affect for example oil price, inflation or fluctuations in the economy. When the economy is thriving and demand is increasing the company might experience increasing profits and this is something that participants in the incentive plan may benefit from as the financial ratios that their performance is measured by increases. It may have an opposite effect when the economy suffers from a recession, profits may be low even though managers are working hard and trying their best. At Boliden, the rules for the incentive plan states that if one division performs badly and the total return on equity is nil, no bonus will be paid. At J&J is no bonus paid either if the company performs badly, if there is no capital there will be no profit. The subjective goals can however be a way to balance the poor economic results, as they are not affected by other factors. The subjective criteria are dependent on the individual’s performance and may compensate when the financial ratios is low due to recession, although our interviewees stated that no bonuses would be paid out if profits are too low.

Contradictions to the agent theory, found by Stathopoulos et al, suggests that poor performing managers are generously compensated and that their reluctance towards risk is not diminished by increase in reward. This also contradicts with the answers we received from the interviewed subjects as they proclaimed that poor performance was not rewarded. Although can poor financial performance be balanced by strong personal efforts, however not if the total profit is nil.

According to Kotsinas at Q-Med, is the profit sharing system used at Q-Med not effective as it does nothing for the motivation. He believes that the system is not differentiated enough and that it is hard for the individual to affect the ratios that the profit is measured by. This proves how important it is that the individual can affect the criteria which he is judged by, and that the participants in the incentive programmes approve of the system.
5.3 The structure of the short-term incentive programme and shareholders’ wealth

There is a trade-off between using objective and subjective criteria to measure performance according to Lawler. The objective criteria are easier to measure, though, on the other hand easier to manipulate in order to receive the bonus even if performance has been poor. However the authors feel that that this claim may be too generalized and not completely accurate because financial information such as the annual report are carefully controlled at a company by different managers and the auditor, who is an independent controller of the accounting. As Lawler and the interviewed personnel mentions it is important that there is trust between the managers and the employees in order for the incentive plan to work. However, none of the participating companies had experienced any problems with cheating employees. This may not be entirely true because this is not something that the companies would like to reveal in this thesis if they would have had problems with cheating.

Objective criteria are according to Lawler easier to judge impartially, subjective criteria on the other hand may be subject to biased judgment by the manager. This same claim was suggested Åhs from Siemens, that managers may give their subordinates a favourable judgment because they know each other and have worked together earlier. According to Åhs this may be avoided by just looking at the performance for a specific year. However, the authors feel that in order to avoid biased judgments, even though the criteria are subjective the goals must be clearly stated to avoid biased judgment, and as Lawler argues the criteria must be measureable in order for the incentive programme to be successful. Bernsmed claimed that it is important that the incentive plan is viewed as fair among co-workers and therefore they do not discuss the amount each executive receives as it is based on his personal performance. Lawler also proclaims how important it is that the employees accept the incentive programme in order for it to work. If the employees do not accept the incentive plan they will not take it seriously, thus they will not be motivated to do a good job. This is may be considered at Siemens and Boliden for example as they have an annual discussion with their supervisor in order to mutually decide the goals for the incentive plan, each year. Including the participant in the discussion may be a way to receive acceptance from the employee.

According to the agent theory the objective goals as financial ratios, is the best criteria as it gives the manager an incentive to work for increased profit. But how do the subjective goals benefit the shareholders? The subjective goals are according to the interviewed personnel, a
way to develop the managers’ skills and encourage certain behaviour by rewarding the increased effort.

5.4 Who benefits from the short-term incentive programme?

The goals that are set must be right for the business and the employee must be able to influence them. When these goals are right they will unite the different divisions in the company into one goal. However, the goals must be correct and up to date in order for the goals to push the business in the right direction. As claimed by Åhs and Byggdesson, Östberg and Bernsmed the incentive programme on their companies are good for the shareholders because when the goals are right the employees will be united towards one goal. Hence the incentive plan unites and motivates managers and their subordinates to work towards a common goal which is to increase the company’s profit.

Nevertheless, the increased profit will benefit both the employees in the incentive programme and the shareholders as it will increase the company’s profit. Thus a well designed incentive programme will be a way for the shareholder to monitor and control the managers.

If the criteria for the incentive programmes are disclosed in the annual report the shareholders will be able to monitor what targets the managers are working towards. The more transparent the system is the more insight will the shareholders have into the system. The shareholders will want to have insight in order to control the managers and to gain knowledge about the target for the business, as the shareholders wealth are dependent on the company’s financial performance.

Another way for the shareholders to receive information from the company is the shareholders’ meeting; it will benefit the shareholders if the incentive programme is discussed there, since they will have more insight and get a chance to influence the structure of the plan and the sum of money.

The companies may benefit from giving the shareholders insight as they need their incentive programme to have credibility. As mentioned in the outlined theory is reputation very important for a public company the article from Harvard Business Review suggests that the board of directors should discuss the incentive plan with the shareholders or at least the main investors. This may be a wise thing to do considering the critique bonuses have received in
media lately. Hence bad reputation can be very destructive for a public company, and therefore is credibility important. However, only the board at J&J, Siemens and Nordea had discussed the incentive plan with the shareholders.
6. Conclusion

In this chapter are the conclusions, discussed in the analysis, emphasized more strongly. The conclusion gives answers to the questions presented in the purpose of this thesis.

The purpose of this thesis was to find answers to these questions:

- Why do public companies choose to have short-term incentive programmes?
- How is the short-term incentive programme designed and how it benefits the company and the shareholders?

We have found in our study that the companies we performed interviews at use short-term incentives not only because it is viewed as a good motivator for the managers to work better and harder but also because they need competitive salaries to attract and keep personnel. If the bonus would be removed they would have to compensate by increasing the fixed salary this would lead to an additional cost for the company when it performs badly, as the bonus would have been nil when profit is nil. We also found contradictions to the agent theory as encouraging risk taking was not a main factor behind the structure of the short-term incentive plan according to the personnel we interviewed.

The short-term incentive plans are structured with the purpose to increase the company’s profit and that is why financial goals are used as a tool for measuring performance. However, the performance is measured by both financial and subjective goals, which both had the intent to make business thrive. The subjective goals are used to encourage and reward a certain behavior and to develop the manager’s leadership skills. When the short-term incentive programme is well structured and reflects the strategy of the business and the participants are motivated by the plan, it will benefit the shareholders as the profit will increase.
References

Interviews

Bernsmed Leif, CFO at Johnson & Johnson Nordic AB (09.12.01)

Bygdeson Maria, manager of People Strategy & Governance at Siemens AB (09.12.03)

Karlsson Peter, Human Resources Compensation & Benefit Specialist on Nordea Bank AB (09.12.03)

Kotsinas Alexander, CFO at Q-Med (09.11.16)

Åhs Kurt-Ove, HR Director at Siemens AB (09.12.03)

Östberg Henrik, Director of HR and sustainable development at Boliden AB (publ) (09.11.31)

Literature References


Electronic References


APPENDIX 1: The English version of the questionnaire

1. Does the short-term incentive programme only consist of an annual bonus?

2. How long have you had your present short-term incentive programme?

3. Which type of targets is the performance based by in order to receive the annual bonus? Who participates in the short-term financial incentive programme?

4. How is this target measured? Why have you chosen to use this/these targets? Who is responsible of evaluating and measure the targets in the incentive plan?

5. Who were responsible for the structure of the short-term incentive plan? Were the management invited to discuss the structure of the financial incentive plan?

6. Has the incentive plan ever been evaluated? In case by whom and why?

7. Which advantages and disadvantages can you find with your incentive plan or incentive plans in general?

8. Has the annual bonus ever been discussed at a shareholders meeting?

9. In what way would you say that the short-term incentive plan benefit the owners?

10. Do you find trust to be an important factor behind the success of your short-term incentive plan? Or would believe any other factor to be important to the success of your incentive plan?
APPENDIX 2: The Swedish version of the questionnaire

1. Består ert kortsiktiga finansiella incitaments program enbart av en årlig bonus?

2. Hur länge har ni haft ert nuvarande bonussystem?

3. Vilken typ av prestationsmått är den årliga bonusen kopplad till? Vilka omfattas av det kortsiktiga incitamentprogrammet?


5. Vem ansvarade för utformningen av det? Fick ledningen vara med och diskutera utformandet av bonussystemet?

6. Utvärderas systemet? När och av vem i så fall?

7. Vilka fördelar respektive nackdelar ser ni med ert bonussystem eller bonus system generellt sett?

8. Har bonus systemet någon gång diskuterats med bolagsstämman (aktieägarna)?

9. På vilket sätt är bonussystemet en fördel för bolaget samt aktieägarna?

10. Anser du att tillit är en viktig faktor bakom att framgången till bonussystemet? Eller vad anser du vara en viktig faktor bakom ert bonussystem?