

Linking Incentive Compensation and EVA to Drive Shareowner Value at



The Coca-Cola Company leads the worldwide beverage industry in terms of volume, profitability, growth, and innovation. Its primary objective as a company is to grow shareowner value over time, and it has been extremely successful in recent years in achieving that objective. The total market value of its stock grew from \$15 billion at the end of 1986 to \$165 billion at the end of 1997.

However, from the company's perspective, much remains to be done. Around the world, the company still supplies less than 2 of the 64 ounces of liquid intake the average person needs each day. And the company's focus remains resolutely on going after the other 62!

To do so, it operates in accordance with three guiding objectives. First, it works to fuel growth within the industry, increasing overall demand for beverage products. Second, it focuses on innovation in every area of the business, including marketing, packaging, and people management. Third, it manages for the long-term, making investments today that will pay off in the future.

Setting the Strategic Measures

To ensure that every decision it makes is sound from a financial and shareowner value perspective, the company is managed from an economic value added (EVA) and economic profit viewpoint. EVA and economic profit are closely linked and serve as decision making tools that allow all associates to ensure they are creating shareowner value with every decision they make and every action they take. EVA is defined as the change in economic profit from one year to the next. Economic profit is defined as net operating profit after taxes (NOPAT) minus a charge for operating capital. In the mid-1980s, the company's financial systems began tracking, measuring, and reporting aggregate economic profit. Through refinements and enhancements, by the early 1990s economic profit data became available on a regular basis at the operating division level (approximately 25 worldwide, geographic units that report in to corporate).

With the availability of the financial data now ensured, and with the increasingly focused effort on creating shareowner value at all levels of the organization, the compensation group of the company led an effort to realign variable pay programs to focus on economic profit. The process was a straightforward one consisting of essentially four steps:

1. Review overall business strategy and key business drivers.

2. Assess alignment of current incentive and stock option programs with those drivers.
3. Redesign incentive and stock option programs to more closely match business needs.
4. Implement and communicate the changes.

The outcome of that process included several key conclusions:

1. Financial measures are the most critical measures of the company's success.
2. Volume and profit results are equally important.
3. Each division should stand alone in its performance and not be rewarded or penalized based on total company performance.
4. Each division should have flexibility to determine the exact distribution of incentive and stock option awards.
5. One universal program design should apply consistently to headquarters and all operating divisions and to all levels of associates.

The resulting program design is best described as a funding pool with flexible distribution to individuals based on value-added contributions to the results. The programs are consistent on a worldwide basis and all associates from mid-level professional and above are eligible to participate. A specific description of the annual incentive and stock option programs follows.

The Annual Incentive Program

Each division, working with senior management, determines an objective for unit case sales of company products (volume) and economic profit (profit). These two objectives become the target for the division for annual incentive purposes. For corporate associates, the target for incentive purposes is the objective for the total company.

At the end of the year, the performance of each division is assessed versus its objectives for the year relative to a funding matrix. The matrix weights volume and profit equally. If divisions meet their objectives exactly, then incentives are funded at 100% of target. If they exceed objectives, they are funded at greater than 100%, and if they fall short, they are funded at less than 100%. The targeted pool itself is simply the total amount required to award each participant in the plan their exact target, which is expressed as a percent of base salary (e.g., 10%, 15%) based on job grade level.

Once the pool for the division is funded, then division management decides how the exact pool will be distributed. Each division has the responsibility to set specific team and individual objectives that link into the total division objectives. Based on individual and team performance against those objectives, each participant then receives a specific annual incentive award, which falls within a broad range from no award to the maximum award. It is the responsibility of each division to make sure that total incentive awards do not exceed the amount allocated and that the total awards balance against the pool.

The Stock Options Program

The process for stock option awards is similar to that of annual incentives: Option pools are funded based on performance against unit case sales and economic profit objectives, and individual option grants are determined based on specific contribution to those objectives.

Stock option awards are considered annually and fall within a minimum to maximum of a specified range, which varies by grade level and is driven by targeted total compensation levels versus the marketplace. Division management considers each eligible associate each year for an appropriate grant and then recommends that amount for approval by the compensation committee of the board. For both annual incentives and stock options, awards for corporate associates come from and must balance against the corporate pool, which is based on total company performance.

Impact of the Programs

The effect on the business of the clear linkage of incentive and stock option awards to economic profit has been very positive. Some of the benefits include the following:

1. More attention is given in the planning process to the amount and cost of capital required to deliver volume and profit results.
2. Managers and associates now focus more daily attention than ever not only on generating volume and profit, but doing so in a way that covers capital costs and enhances shareowner value.
3. The communication efforts surrounding the importance of value-based management are reinforced financially twice a year through incentive and stock option awards.
4. The economic profit levels of the company and the resulting increase in shareowner value continue to grow at healthy rates. Figure 3-1 shows that as economic profit grew an average of 20.2% per year for 10 years ending with 1997, stock price grew an average of 30.2% per year for the same period.

Even though the plan is working well and the company's financial results are strong, there are still aspects of this approach that Coca-Cola continues to work to improve.

One of these is the budget process. Since so many financial rewards are directly tied to performance versus budget (at both the division and corporate level), the company works constantly to ensure that business plans are set with the same degree of difficulty across all divisions. In other words, senior management has regular dialogue with the operating units to make sure they are planning on capturing all available growth in volume and profit in both the short-term and the long-term. Such judgments are rarely simple ones,

but they are necessary to ensure both business growth and equitable opportunities for financial rewards for those divisions that perform well.

A second constant challenge relates to communication to the individual participant. Since both pool funding and individual or team performance can vary, it is difficult to explain to an individual precisely what his exact reward would be under different performance scenarios. For instance, a participant could perform exceptionally well, but if the division does poorly, then his payout could be reduced significantly because the overall pool is lower. Explaining this team-based, zero-sum approach in a simple and easily understood manner is a constant challenge.

A final challenge relates to making sure that every participant has some line-of-sight between his or her actions and the financial rewards received from these plans. Part of this endeavor involves general education about value-based management (a major priority of the company) and how decisions should be made. Part of it involves clear objectives that relate to and drive portions of the volume or economic profit equation. The final piece involves demonstrating how the individual's reward links back to the overall value added to the business.

A fundamental communication to all associates at the company is: "Everything you do today will either create or destroy value for The Coca-Cola Company." With that level of focus on value creation, the close linkage of incentive and stock option programs to EVA currently in existence is exactly right for the company. The programs are working well, are fully aligned with business needs, and no major changes are planned.

However, since another shared value is continuous discontent with the immediate present, the company will continue to be vigilant in monitoring all aspects of its rewards programs to ensure they improve, evolve, and change as necessary to support the company on its infinite journey to create shareowner value.