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## Promoting Investments in Intangible Organizational Assets through Aligned Incentive Compensation Plans

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# Promoting Investments in Intangible **Organizational Assets** through Aligned Incentive Compensation Plans

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**BY ALIGNING EVALUATION AND COMPENSATION PLANS WITH THE CONTINUED GROWTH AND DEVELOPMENT OF ORGANIZATIONAL ASSETS, A COMPANY CAN ENSURE ITS STRATEGIC BUSINESS UNIT MANAGERS CONTINUE TO FOCUS ON ITS LONG-TERM STRATEGIC OBJECTIVES RATHER THAN SACRIFICE THE FUTURE FOR SHORT-TERM GAINS.**

**EXECUTIVE SUMMARY** Strategic business unit managers are often evaluated based upon return on investment targets—targets that reward lower expenses and lower investments. This focus, however, may be at odds with the strategic objectives of the larger organization that require investment in organizational assets, generally large-scale intangible assets that form the basis for achieving the organization's strategic goals. Investments in these intangible assets have the potential to reduce profits in the short term but enhance profits in the long term. To encourage investment in organizational assets, organizations must align their compensation schemes with their long-term objectives. We examine the experiences of the Steak n Shake Company to illustrate how one company aligned the objectives of its business unit managers with its strategic plan to build human capital.

**T**oday's global business environment places increasing pressures on large companies to create or expand their global presence. More than 20 years ago, however, Gary Hamel and C.K. Prahalad noted that a global brand franchise requires significant investments that are

greater than the resources and scale found in individual business units.<sup>1</sup> In practice, however, decentralized organizations often focus on business units and develop incentive compensation schemes that reward unit performance. This may interfere with positive returns at the organizational level. Hamel and Prahalad claim that

few companies with a strong focus on strategic business units are able to successfully build either global distribution systems or brand positions. They suggest this occurs because strategic business unit managers are often evaluated based upon return on investment targets that reward lower expenses and lower investments—a focus that is at odds with the strategic objectives of the organization as a whole. Within this article, we discuss the importance of developing organizational assets, the large-scale, generally intangible assets that increasingly form the basis for achieving the organization's strategic goals. Next, we provide an overview of a compensation scheme often used in organizations with a focus on business units. Finally, to illustrate the need to align business unit incentives with organizational strategic goals, we highlight the experiences of the Steak n Shake Company as it works to align the objectives of business unit managers with its strategic plan.

#### **ORGANIZATIONAL ASSETS: IMPORTANCE AND EXAMPLES**

A review of recent business articles indicates that many U.S. companies identify intangible organizational assets as key factors within their long-term strategies. Some of the more frequently mentioned assets include innovation, brands, research and development capabilities, human capital, and supply chain efficiencies.

**Innovation.** Innovation and its link to enhanced profitability is well documented in the business press.<sup>2</sup> To develop future products and services perhaps not yet identified by consumers, companies are developing organizational cultures, processes, and employee teams that are key to innovation success. For example, since 2000, Whirlpool has worked to increase innovation by assigning a diverse group of 75 employees, ranging from hourly workers to vice presidents, to a nine-month innovation training experience.<sup>3</sup> The specific annual cost figure attached to Whirlpool's innovation is between \$20 million and \$40 million.<sup>4</sup>

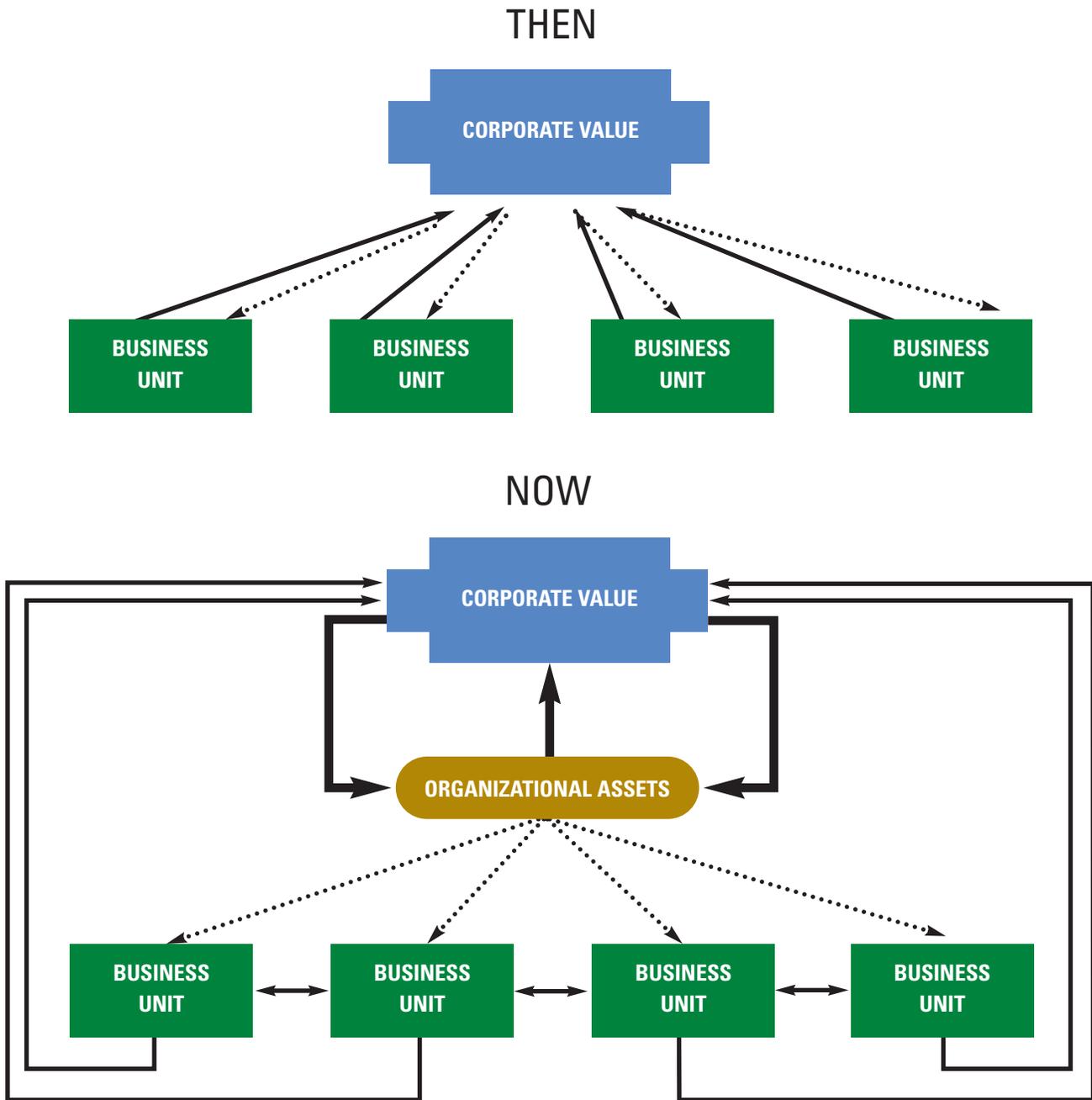
**Brand Value.** The importance of building the value of global brands is exemplified in the annual ranking of the Top 100 brands as determined by Interbrand and published annually in *Business Week*.<sup>5</sup> Investing in brand building is seen as a means to increase revenue and

operating income through higher sales volumes and/or premium pricing. Although scholars may quibble over the methods used to calculate brand values, they agree there is value in brands despite the fact that this organizational asset is seldom reflected on the balance sheet. The emphasis on brand building is illustrated by Adidas's and Nike's numerous brand-related investments made in conjunction with world soccer and the 2006 World Cup and designed to capture the global sports market. One report notes that Adidas has invested more than \$500 million in brand-building expenses or commitments since 2004, and Nike committed \$144 million to extend a single sponsorship through 2018.<sup>6</sup>

**Research and Development.** Research and development (R&D) expenses allow companies to identify new products they believe will improve future revenue and profits. The level of R&D expenses varies by industry; the highest percentage of R&D to revenue dollars is usually found in the pharmaceutical industry. For example, Eli Lilly & Co.'s 2004 annual report lists R&D expense as \$2.7 billion, or 19% of net sales.<sup>7</sup> The timing and extent of return from R&D investments is uncertain, which increases pressure on corporate executives to justify and continue these investments. For example, Pfizer spent more than \$21 billion on R&D between 2000 and 2004, but its last blockbuster drug was introduced in 1998. As an interim strategy, Pfizer and other pharmaceutical firms seek out and acquire new products developed by small companies.<sup>8</sup> A similar pattern is seen in the consumer products industry. Procter & Gamble (P&G) spends a great deal more than the average firm on R&D, as evidenced by the \$1.8 billion (3.5% of sales) it invested in 2005.<sup>9</sup> Even at this level of investment, however, CEO A.G. Lafley introduced initiatives to obtain more than half of P&G's new product ideas from outside the company, a profound change from the 20% that was historically derived from outside sources.<sup>10</sup>

The R&D expenses listed above are reported at the consolidated level. Operationally, R&D expenses are often associated with specific initiatives undertaken within specific business units. Business unit R&D efforts may not prove sufficient to achieve the organization's strategic objectives, however, and they may also be subject to the business unit managers' efforts to

**Figure 1: Change in Corporate Value—Then and Now**



manipulate R&D expenditures to meet profit goals. Even when R&D is viewed at an organizational level, there may be efforts to curtail current-year expense. For example, there is evidence that companies with CEOs close to retirement and companies that plan to issue new equity capital both decrease R&D expenditures.<sup>11</sup>

**Human capital.** Investing in employees, sometimes referred to as developing human capital, has the poten-

tial to create yet another organizational asset. Almost two decades ago, Motorola began requiring every employee to engage in a minimum of 40 hours of job-related education and training per year. By 1996, Motorola was investing \$200 million annually in workforce training and education.<sup>12</sup> More recently, United Airlines initiated a ramp worker training program designed to reduce ground time between flights. Dur-

ing 2006, the airline plans to train 1,200 ramp workers through a series of “Pit Crew U” training sessions in which employees learn valuable job-related skills while engaging in simulated NASCAR pit crew experiences. United describes the training as “part of a multimillion dollar investment that includes new equipment and bag scanners.”<sup>13</sup> United plans to expand the training to customer service agents in 2007. Training initiatives can also improve human capital in related businesses. For example, DaimlerChrysler’s training academy is in the midst of a long-term initiative to improve dealership profitability. Adding training courses and a certification program has increased sales by 20.3% and reduced employee turnover by 1.3%.<sup>14</sup>

**Supply Chain.** Competitive advantage resulting from supply-chain efficiencies is often linked with Wal-Mart, but the retailer is far from alone. Whirlpool recognized the importance of improving its supply chain and invested tens of millions of dollars in its distribution systems during the early 2000s, a period of significant financial cutbacks within the corporation.<sup>15</sup> The investment resulted in long-term cost savings, including lower inventory levels and a proper product and placement mix that resulted in higher sales levels.

The organizational assets described above contribute to a business unit’s success and, in turn, contribute to the financial success of the organization. The enhanced profits and cash flows allow the organization to invest in additional organizational assets, creating a circular pattern of successful investment, illustrated in Figure 1.

Within Figure 1, the intangible assets we have discussed are referred to as organizational assets. Developing each asset requires significant investment of organizational capital, but few of the investments generate additional earnings and net positive cash flow in the year in which they are made. Some investments will not result in positive returns for years. For example, consumer product firms’ investments in innovation and R&D may result in new products and new revenue streams within a year or two, but pharmaceutical firms’ investments may not result in new revenue streams for five to 10 years, if ever.

Because generally accepted accounting principles (GAAP) define organizational assets as intangible assets, these assets are generally accounted for differently than

## Figure 2: Investments in Traditional and Organizational Assets and ROI Calculations

Assume a company invests \$100 financed with income and new debt. The new equipment will result in cost savings of \$10 in Year 1. The investment in brand enhancement does not generate additional revenue or income in Year 1.

	PRO-FORMA RESULTS		
		TRADITIONAL INVESTMENT: NEW EQUIPMENT	ORGANIZATIONAL ASSET INVESTMENT: BRAND ENHANCEMENT
	YEAR 0	YEAR 1	YEAR 1
Assets	\$200	\$300	\$200
Liabilities	100	170	180
Equity	100	130	20
Net Income	\$20	\$30	(\$80)
Return on Investment	10%	10%	(40%)

traditional brick-and-mortar assets. Where fixed assets are capitalized and then depreciated over the years during which the asset contributes to the company’s earning stream, organizational assets—unless acquired as part of a business combination or, in rare cases, purchased outright—are developed through investments that must be expensed at the time incurred. As such, investments in these organizational assets often reduce short-term profitability with the hope and expectation of increasing long-term profitability, and they fail to appear on the balance sheet or in the notes to the financial statements.

Figure 2 compares the ROI impact of investing in intangible organizational assets with tangible assets. It is obvious that investing in traditional assets increases the base of the ROI calculation. The example also projects that income will increase as operating expenses are decreased or new revenue streams are possible. Either impact is generally projected within the capital budgeting proposals of successful projects. Because of their classification as intangible assets, however, organizational asset investments increase expenses without increasing the recorded asset base. Also, because these investments

reduce short-term profitability, business unit managers compensated under incentive compensation schemes linked to their unit's financial performance will likely avoid investing in organizational assets. Rather, the unit managers will invest in projects that have a direct, immediate, and positive impact on the results of their unit as well as their bonus or other incentive-based compensation. Achieving short-term higher ROI may also increase a manager's opportunity for advancement within the organization, providing additional pressure to invest in unit-specific assets (and resulting income) rather than those that benefit the entire organization.

To avoid the conflicts between organizational strategic objectives and managers' performance measurement schemes, executives charged with accomplishing the strategic plan should work with appropriate accounting personnel to determine the current organizational levels and accounts in which organizational asset investment is captured. Figure 3 illustrates that these expenses can appear in at least three different income statement line items. The executive and accounting personnel can then work to align the strategic objectives and employee evaluation systems by developing accounting metrics and incentive schemes consistent with the strategic objectives of the organization.

#### **AN ORGANIZATIONAL-ASSET-FRIENDLY COMPENSATION SCHEME**

The conflict between the organization's desire to invest in organizational assets and the business unit manager's desire to increase ROI generally occurs because the business unit manager is compensated through a performance-based pay system. Performance-based pay has three primary benefits. First, it typically attracts the best (i.e., most productive) employees to a company. Second, it provides employees with a strong incentive to work hard, because their pay literally depends on it. In addition, variable pay schemes mean that when the company is doing well, employees benefit in the form of higher compensation, but when the company is doing poorly, employees bear some of the burden in terms of lower compensation. Thus, variable pay shifts some risk from the company to the employees. Despite these obvious advantages, most companies do not rely exclusively on variable pay schemes. Instead, they use

**Figure 3: Potential Impact of Segment Income from Investments in Organizational Assets**

INCOME STATEMENT LINE ITEM	INCREASES IN EXPENSES
Revenue	
Cost of Sales	<ul style="list-style-type: none"> <li>◆ Workforce Improvement Costs</li> <li>◆ Research and Development</li> <li>◆ Changes in Supply Chain</li> </ul>
Gross Profit	
Selling, General, & Administration	<ul style="list-style-type: none"> <li>◆ Training and Development</li> <li>◆ Advertising and Brand Enhancement</li> <li>◆ Segment Margin</li> </ul>
Other Income and Expenses, including Corporate Overhead Charges	<ul style="list-style-type: none"> <li>◆ Costs Subsidized by Corporate, Allocated to Business Units</li> </ul>
Business Segment Income	

salaries or some combination of variable pay and salaries.

One problem with variable pay schemes is that it is costly, and often difficult, to measure an employee's contribution. While it may be straightforward to measure a worker's output on an assembly line, it is not as easy for a VP of finance or marketing manager. Even if a measurable performance indicator can be identified, care must be taken to ensure that it is the right measure. Selecting the wrong measure can have disastrous results for a company. For example, paying line workers strictly on the basis of number of units produced may result in a fast-moving assembly line, but it does not guarantee that the units produced will be defect-free. To solve this problem, a measure that better aligns the efforts of the employees with the strategic goals of the organization is needed. For example, Lincoln Electric, long recognized as a leader in performance-based pay, only pays workers for units produced that meet a specific quality standard, thus solving the quantity vs. quality dilemma on its shop floor. Measurement becomes even more problematic when many employees work together as a team and it is difficult to determine how much of

the team's success is attributable to the efforts of each team member.

The key to a successful performance-based pay system is identifying appropriate performance metrics. In the context of organizational assets, this means that particular care must be given to balancing short- and long-term incentives. Developing organizational assets may place short-term downward pressure on traditional earnings measures. If such measures continue to be the sole basis for performance-based pay, managers may have a disincentive to invest in organizational assets. The solution, as illustrated by the experiences of the Steak n Shake Corporation, is to either modify performance metrics or alter the way in which investment costs are handled at the organizational level.

#### **BUILDING A BETTER "BENCH" AT STEAK N SHAKE**

In the game of basketball, coaches often seek to create a large group of skilled players so that there is little drop in player quality as the primary players are rotated out of the game and other players enter. This is referred to as having a deep bench—an analogy that resonated with the top management team at Steak n Shake as they worked to build their store management teams to achieve new growth initiatives.

Steak n Shake, founded in 1934, is a unique restaurant chain that positions itself between quick-serve restaurants (e.g., McDonald's) and casual dining (e.g., TGI Friday's). Its primary point of differentiation is as an alternative to fast food, which it achieves through the following features:

- ◆ Open 24 hours a day;
- ◆ Food cooked to order and served on china plates;
- ◆ Hand-dipped milk shakes and steak burgers made from steak trimmings;
- ◆ Trained and friendly wait staff; and
- ◆ An average check price per person of approximately \$6.50.

Growth is driven by the number of restaurants (referred to as "stores" within Steak n Shake), the number of return customers, the size of the customer's check, and the resulting margin. To maintain revenue and profit growth, the Steak n Shake management team focused on institutional knowledge, benchmarking oth-

ers in the industry, measuring employee turnover, feedback from "mystery shoppers," and guest satisfaction scores. Combined, these factors contribute to the successful application of the virtuous cycle, which is viewed as the key to success in the highly competitive restaurant business. Steak n Shake operationalizes the virtuous cycles as follows: Appropriate levels of well-trained employees should result in more satisfied customers, larger revenue per customer order, and more repeat customers. This, in turn, results in higher employee retention levels, which starts the cycle once again. Well-trained employees with low turnover rates are key to Steak n Shake's strategic objectives and result from repeated investments in its human capital. Combining human capital with appropriate menu items and restaurant sites should attract new and existing customers, increase revenues, and enhance the value of the brand.

During the late 1990s, Steak n Shake targeted an aggressive growth strategy, but its plans were constrained by a lack of experienced field leaders capable of establishing successful new restaurants. A typical Steak n Shake restaurant has a management team of five: two or three shift managers, a restaurant manager, and a general manager. A general manager must have six to 12 months of experience to head up a new restaurant. Hiring managers from other establishments solved the simple numbers problem, but it also introduced new problems. Recently hired managers were not familiar with Steak n Shake's unique culture and industry niche. While moving an experienced manager from an existing restaurant to a new restaurant allowed the new restaurant to be adequately staffed, the vacancy this move created required either the transfer of another general manager or the promotion of a well-trained restaurant manager. The logical solution was to train new managers in existing restaurants and then assign them to the new restaurants. These new managers added to the depth of Steak n Shake's "bench" and provided the primary component of the virtuous cycle.

To train new managers, corporate officials asked restaurant managers at qualified stores to hire and train what were referred to as "an additional unit of management." After the training period, this new hire was transferred to open a new store. Current managers were ready and willing to take on this added salary cost to

further the organization's goals and build the organization's "bench." At the end of the reporting period, however, many of the managers found that their restaurant's profitability was below plan, and they lost their bonus payments. Soon after this realization, experienced managers refused to accept management trainees—and the additional salary cost—at their restaurants.

This response illustrates two problems with the training plan. First, the current managers continued to be evaluated by the same criteria used before the training plan was adopted. Second, even if the managers anticipated that their restaurant costs would increase with the salary of the trainee, it may have been difficult to offset that salary cost unless another unit of management was eliminated, most likely a shift manager. Other attempts to reduce costs, such as understaffing servers or cooks, would negatively impact guest satisfaction scores and lead to less-satisfied employees, higher turnover, and further declines in guest satisfaction, creating a downward spiral of store performance.

To resolve the conflict between strategic goals and the bonus plan, Steak n Shake management developed a compensation plan that matched its business needs. The solution was a two-prong realignment of performance measures and strategic organizational objectives. The training program continued with one significant change. Under the new system, if a store was fully staffed and eligible, the corporate office provided it with an extra unit of management and covered the cost of training the manager. Thus, stores received a new unit of management at no cost. Current managers were once again receptive to the idea of receiving a management trainee at their stores, because the additional manager did not jeopardize the current managers' abilities to meet their budgets and receive bonuses. In addition, and in accordance with the virtuous cycle, the store's ability to meet customer satisfaction and turnover goals was enhanced with an additional employee in the store working toward achieving customer satisfaction and performance goals.

Did the new training plan work? In 2005, there were between 130 and 150 management trainees in the program. Training stores achieved lower associate turnover rates and enhanced guest satisfaction. From a corporate standpoint, there were more successful store openings.

From 2003 to 2005, three metrics improved: associate turnover dropped from 190% to 135%, management turnover dropped from 30% to 26%, and customer delight rose from 53% to 61%.

Equally important, new stores experienced a steady increase in guest satisfaction as the training program unfolded. From an organizational view, investing in the training program is relatively costly, adding \$1.5 million in restaurant costs in 2005, with the investment amount expected to grow to \$2.5 million in 2006. All of these expenses are absorbed at the organizational level. Steak n Shake's top management clearly sees this program as beneficial—it is a featured part of press releases, the annual report, and conversations with the investment community. In these conversations, Steak n Shake articulates the extent and expected impact of the investment, as measured by return on new store investment, employee turnover, and guest satisfaction.

#### **ALIGNING BUSINESS UNIT AND CORPORATE OBJECTIVES**

There are three lessons that can be learned from the Steak n Shake experience. First, in order to successfully grow a company, it may be necessary to make significant investments in intangible organizational assets. In the case of Steak n Shake, this organizational asset was human capital. For other companies the key investment lever may be global brands, R&D, or supply chains. Investment in organizational assets requires that both corporate and unit managers switch their focus from short-term performance goals to long-term strategic objectives. To facilitate this shift, it is critical to realign performance management and incentive systems, not only for executives but also for employees at all levels of the company.

Second, in the case of intangible organizational assets, earnings growth does not often come as quickly as the investment community may like. Therefore, the second change involves creating a coherent and transparent story to communicate the strategic organizational objectives to the investment community. Although communicating how organizational assets will be created and how they will provide value in the long term may not resonate well in the year of introduction, consistent positive results over the long term will cause many critics to for-

get their initial concerns. The use of short- and medium-term nonfinancial measures is helpful in communicating the company's progress toward its strategic objectives, and it provides a focus that is consistent with and positioned to attract long-term investors.

Third, it is important to acknowledge that the messages communicated to business managers are often contradictory. On one hand, managers have repeatedly been told that they should understand the business's cost behavior and work toward cost reductions. On the other hand, they are told to invest resources to build future revenue sources, often resulting in higher short-term expenses. Further complicating matters is the fact that often the business unit investments that provide superior long-term returns are those that contribute to large-scale, intangible organizational assets that benefit all business units. Because the cost of these investments originates at the business unit level, corporate officials must work to gain buy-in from unit managers through appropriate incentives and compensation schemes. Contrary to traditional measures, these incentives and schemes may include corporate subsidies, points earned by supporting corporate-level activities, or recognition that balancing business unit and corporate initiatives may result in reduced ROI at the business unit level. By explicitly recognizing the impact of corporate initiatives on business unit performance and aligning the business unit incentives with those of the larger corporation, business unit managers can more easily invest in the strategic initiatives that promote the company's competitive advantage, whether those initiatives are focused on differentiation, revenue or earnings growth, or reduced costs. ■

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