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# **Incentive programs – a corporate governance perspective on Swedish commercial state owned firms**

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## Abstract

- Title: Incentive programs – a corporate governance perspective on Swedish commercial state owned firms
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- Key Words: State owned firms, incentives, compensation, agency costs
- Purpose: We would like to learn more about how the restrictive policy against incentive programmes affects the board's of Swedish state owned commercial firms ability to govern management in an efficient way. We also want to find out if there are different consequences in reference to this that are not directly linked to corporate governance issues. Our empiric observations have been made in order to profoundly explore the subject and examine it through the eyes of professional individuals, all expressing different views and standpoints.
- Methodology: For this master thesis we have chosen to employ an *abductive* approach and we started our work by performing a thorough examination of literature on the subject. The aim of our research was to determine if the incentive programmes used in commercial state-owned firms in Sweden are effective according to contemporary theory. Since this is a widely debated subject we have tried to gather different views when choosing respondents for our personal interviews.
- Conclusion: We conclude that the most efficient structure is when an active board is complemented by a well structured and individualised incentive programme. However, this thesis conclude that this structure is not possible given the current guidelines and policies employed by the state, which in turn might lead to sub optimizations in the governing.

Abstract .....	2
Chapter 1: The introduction .....	5
1.1 Background .....	5
1.2 Problem Description.....	8
1.3 Objective .....	8
1.4 Thesis Outline .....	9
1.6 Delimitations of the study .....	9
Chapter 2: The theoretical framework.....	12
2.1 Compensational key drivers .....	12
2.2 Agency costs of managerial discretion.....	13
2.3 The board of directors .....	13
2.4 Aligning pay with performance.....	15
2.5 Incentives reaching over multiple time periods .....	17
2.5.1 Compensation Bank .....	17
2.5.2 Divergent Incentive Schemes.....	17
2.6 Incentive Design.....	18
2.7 Compensational plans .....	19
2.7.1 Stock options .....	20
2.8 Measurement systems for attaining corporate value creation .....	20
2.8.1 EVA – Economic Value Added , .....	21
2.8.2 EVA in state-owned firms.....	22
2.8.3 SVA – Shareholder Value Added .....	22
2.9 The real key to creating wealth , .....	23
2.10 Oktogonen .....	24
2.11 MUST.....	24
Chapter 3: The methodology.....	26
3.1 Choosing approach .....	26
3.2 Data gathering .....	26
3.3 Data selection .....	27
3.3.1 Primary and secondary data .....	27
3.4 Interviews .....	28
3.4.1 Standardized and unstandardized interviews .....	28
Chapter 4: The empirical study .....	36
4.1 Swedish Aspect on Incentives.....	36
4.2 Facts from state-owned firms.....	36
4.3 Primary data .....	37
4.4 The role of the Board .....	38
4.5 Incentive programmes .....	40
4.6 Managerial Compensation.....	41
4.7 Incentive design.....	43
4.8 Measurements.....	45
4.9 Considering Macroeconomic effects.....	47
4.10 State vs. private owner's perspective.....	47
Chapter 5: The Analysis .....	50
5.1 Swedish aspects on incentives.....	50
5.2 Incentive programmes .....	50
5.3 Incentive design.....	52
5.4 Measurements.....	53
5.5 The role of the board .....	55

5.6 Considering Macroeconomic effects.....	56
Chapter 6: The concluding thoughts .....	58
References .....	61
Litterature & articles .....	61
Industry department Publications on State ownership .....	62
Web .....	63
Interviews .....	63

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## Chapter 1: The introduction

*Corporate governance is a hot topic. During the first years of the 21<sup>st</sup> century corporate governance and the mitigation of managerial discretion have been massively debated. The main focus of the debate has surrounded the questions as to how managers will be encouraged to perform in a legitimate and trustworthy fashion. How boards affect managers to set the overall goals and aims of their firm's owners at the top of their agenda. The state owned firms aim to achieve long term sustainable value creation for their owner; the citizens of Sweden. This chapter aims to introduce the reader to the high set goals of the Swedish state corporate governance, its resignation towards incentive programmes and the problem set derived from this.*

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### 1.1 Background

State owned firms showed an increase in their after tax earnings of 71 percent during 2005 and make out a substantial part of Swedish business. Earning after tax totalled at SEK 52,2 billions. The businesses range from opera to mining, from gambling to real estate. The government has set societal goals for some of the companies such as Samhall AB, while others are monopolies by legislation such as AB Svensk Bilprovning, the motor vehicle inspection company. However, most of the state-owned companies are active in a fully competitive market without having to fulfil special societal goals<sup>1</sup>.

The goal for companies active in a competitive market is to create value. Companies with special societal goals should create value primary through accomplishing those goals, and secondly by using their resources efficiently. The state policy has been implemented in order to set a good example when it comes to corporate governance issues. This is displayed amongst other this when it comes to taking ethical, social and environmental responsibility. Alongside working against racial and sexual discrimination. The state also aims to set standards when it comes to create a work-place where employees can not only work but also prosper<sup>2</sup>.

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<sup>1</sup> State ownership policy 2005

<sup>2</sup> Ibid

The ownership policy of the state take three tools in regard when managing companies: *financial reporting*, *capital structure* and *board nominations*<sup>3</sup>.

*Reporting* serves the purpose of creating full transparency about the performance of the state-owned companies and how the state manages the portfolio. Transparency is a matter of democracy as well as ensuring that the state's resources are used efficiently.

*Board nominations* should aim to create efficient boards by appointing highly skilled people with respect to the company's operations and the phase that the company is in.

The *capital structure* should be optimised with respect to both borrowed and own capital, and provide an incentive to focus on the company's core business.

It is the aim of the industry department to produce reports that are in level with reports produced by the private sector. This becomes especially important since the firms are owned by the citizens of Sweden.

When it comes to management compensation the state should pay competitive wages ensuring that it has the capacity of employing highly skilled professionals. However it does not lie in the interest of the state to pay out larger compensations than what is the average of the private sector. The state has since 2002 implemented a restrictive policy regarding variable compensation through monetary incentives.<sup>4</sup>

Contradictory to this the use of variable pay is increasing internationally, with Latin American and Asian nations making rapid strides in relation to bonus-paying employers in the US and Europe. In the UK 85% of private sector organisations and 32% of public sector organisations pay bonuses - up from 69% and 22% respectively in 2005.<sup>5</sup>

From a closer look the conditions tell us that the state, to a certain extent, want their commercial firms to act like ordinary private companies<sup>6</sup>. The state reaches out to try to impose the same demands on their portfolio firms as the private sector would do, but do they

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<sup>3</sup> State ownership policy 2005

<sup>4</sup> Ibid

<sup>5</sup> Towers, P. (2006)

handicap their firms by not allowing the most effective corporate governance system? There are naturally certain considerations to take when representing the state, but what should set the standards for a firm, political concern and public complains or maximization of equity value? And further, since the state represents the people, are not they the proper owners?

Naturally there are political benefits to gain from publicly expressing great concern and promising harsh legislation and increased monitoring in state-owned firms. The latest guideline that was presented in 2003 partly changes the reality for the state-owned firms. The CEO is now unconditionally excluded from all incentives programmes<sup>7</sup>.

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<sup>6</sup> Annual report of state owned companies 2004

<sup>7</sup> Annual report of state owned companies 2004

## **1.2 Problem Description**

State owned firms operate in an environment affected by duality in the sense that their owner is balancing political and business aspects against each other. The state has issued several new guidelines and policies constraining the implementation and structuring of incentive programmes. One consequence is that state owned firms that formally used to employ incentives programmes have now abolished or restructured them. The restructured incentive programmes do not resemble the old in many ways. As an example do the guidelines exclude the CEO from participation in any incentive programme implemented in a state owned firm.

- Is there any theoretical or empirical rationale behind the guidelines?
- Are the state owned firms applying the same business considerations as private firms when deciding on their corporate governance?
- From an agency perspective; which are the main features dividing state from private owned companies?
- Are there specific considerations taken by the state as an owner and if, how do these considerations affect their governing?
- Can an incentive programme be structured in a way that respects both the theoretical rationale and the particular regards that has to be taken to the state as an owner?

## **1.3 Objective**

We would like to learn more about how the restrictive policy against incentive programmes affects the board's ability to govern management in an efficient way. We also want to find out if there are different consequences in reference to this that is not directly linked to corporate governance issues. Our empiric observations have been made in order to profoundly explore the subject and watch it through the eyes of professional individuals, all expressing different views and standpoints.



## **1.4 Thesis Outline**

Chapter 2 consists of a theoretical framework on which the empirical study and analysis are based. In Chapter 3 we describe the methodology behind the measures taken by us in order to reach our results. The results of our empirical study are presented in chapter 4 and later analysed in chapter 5. In Chapter 6 which is the final chapter we assemble our concluding thoughts.

## **1.5 Target group**

Our target group consists of the owner committee at the Industry Ministry, board of directors of the state-owned firms as well as the research society.

## **1.6 Delimitations of the study**

Our research is delimited to concern incentive programmes in wholly Swedish state-owned firms acting on competitive markets.

Sweden has a long history of state-owned firms. Being ruled by the Social-democrats for more than a decade has certainly affected that structure and it was not until 1991 that the Swedish congress decided to sell out 35 state owned companies to private owners and allow competition in certain other fields. Today, 43 firms remain completely owned by the state whereas 14 are jointly owned firms listed on the Stockholm Stock Exchange (SAX). The state is the largest single stock-owner on the SAX and 200,000 Swedes rely on the state as their employer.

The state-owned firms are separated in two groups operating under entirely different conditions;

<b>Regular competition</b>	<b>Special societal responsibilities</b>
<i>Demands on ROI are defined by the market.</i>	<i>Operates on markets of special conditions.</i>
27 firms	25 firms
147 952 employees	47 741 employees
68 058 of which abroad	83 of which abroad
68% of turnover	32% of turnover
81% of net profit	29% of net profit

This thesis will, as mentioned in chapter one, only focus on the firms of the left column which operate under “normal” circumstances.

Since 1998 owner and governance related issues are handled by a special 25 member group within the Industry Ministry. The intention is that the state-owned firms should have the same fundamental opportunities and the exact same demands on their operations as privately owned firms. This is assumed to ensure long term competitiveness, value creation and effective allocation of capital apart from the fact that it will abolish unlawful competition.

The firms are run, measured and examined from these specific standards:

- Value creation (i.e. ROE)
- Capital structure (i.e. solvency)
- Dividend policy (i.e. certain share of net profit)

These standards are not identical for all commercial state-owned firms but vary in reference to firm structure, market conditions, financial condition and maturity. A general demand is for the firm to balance the financial risk and the business risk since the state wish for a sound total risk in their portfolio. The specific financial aims are revised on annual meetings and can

be adjusted for instance if the total profitability in a certain area is expected to decrease in the long run or if the general interest rate changes dramatically.

## Chapter 2: The theoretical framework

*If there is a separation between ownership from control of operations how can the design of incentives help to alleviate the resulting agency costs? This chapter aims to make up a theoretical framework on which our thesis will be based.*

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### 2.1 Compensational key drivers

There does exist a correlation between managerial compensation and shareholder wealth. Jensen & Murphy explain the relationship between CEO bonus, salary compensation and shareholder wealth. Correlations have been discovered between CEO compensation and firm-specific changes in shareholder wealth, even after accounting for the company performance relative to the industry and relative to the economy.<sup>8</sup>

There further more exists a correlation between managerial compensation and investment policy, debt policy and firm risk. Managers that display a higher sensitivity between *CEO wealth* and *stock volatility* implement riskier policy choices. This includes relatively more investments in R&D, less investment in PPE, more focus, and higher leverage.<sup>9</sup>

This is especially true in smaller firms where the correlation between pay and performance is stronger, much due to the fact that the CEO wealth is more affected by the firm stock price in smaller firms, which is explained by the fact that CEO's of smaller firms generally hold more stock.<sup>10</sup> There is however other factors that are even more important like the size of the firm that influence the CEO compensation to a large extent.<sup>11</sup>

Harsh criticism is aimed at companies that employ a traditional bonus system based on the attainment of planned levels of performance. This system is said to have different kinds of weaknesses. The determination of the present budget will cause extensive negotiations since it is in manager's interest to keep the budget at a low enough level for him to achieve full bonus. This will presumably lead to lower expectations on investments and projects undertaken and

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<sup>8</sup> Jensen, M. Murphy, K. (1990)

<sup>9</sup> Coles, J.L., Daniel, N.D., Naveen, L. (2006)

<sup>10</sup> Ibid.

<sup>11</sup> Jensen, M. Murphy, K. (1990)

might push managers toward being untruthful to the board of directors approving the budget.<sup>12</sup>

## **2.2 Agency costs of managerial discretion**

Agency costs may be derived from the effects of managerial self-interest. Agency costs are as real as any other costs. The level of agency costs is dependent, among other things, on statutory and common law and human ingenuity in devising contracts.<sup>13</sup> Managers may employ different measures to enrich themselves on the expense of the company and the shareholders.<sup>14</sup> Some measures are very direct and even criminal such as manipulation of earnings and dividends with the intent to boost their own personal bonus and siphoning off corporate assets. Others are more indirect and harder to come to terms with, these include empire building, excessive diversification, bias toward investments with near-terms payoff, underemployment of debt, “packing the board” and management entrenchment.<sup>15</sup> In an optimal contracting model the relationship between firm performance and managerial incentives is insufficient to identify whether managers have private benefits of investment, as in theories of managerial entrenchment<sup>16</sup>. Managers are normally less diversified personally and less risk tolerant than shareholders are and therefore they engage in activities that will further secure their own position.<sup>17</sup>

Agency costs of equity can be mitigated by structuring the managerial compensation so that it closely aligns the managerial interests with interest of the shareholders’. Consequently, there is a positive relation between CEO compensation of all-equity firms and accounting performance measures.<sup>18</sup>

## **2.3 The board of directors**

Boards of directors are expected to be alert protectors of shareholder’s interests. In order to accomplish this goal the board can assume different roles, which are generally divided into

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<sup>12</sup> Jensen, M. et al, (1990)

<sup>13</sup> Jensen C. M. et al, (1976)

<sup>14</sup> Ogden et al., (2004)

<sup>15</sup> Ibid.

<sup>16</sup> Aggarwal, et al, (2006)

<sup>17</sup> Rappaport, A. (1998)

<sup>18</sup> Copeland et al (2005)

three categories; *control*, *strategy* and *service*. Board of directors can monitor managers to *control* their behaviour; they can influence *strategy* by being involved in strategic decision making; and they can *service* the board by providing resources, advice and counsel. The board carries a responsibility to be attentive when trying to maximize shareholder value and are therefore not recommended to take a passive stance.<sup>19</sup>

The average corporate board consists of 6-12 members including corporate insiders as well as outsiders. Importing Anglo-American corporate governance systems competencies into boards has proven successful. Such an import signals willingness on the part of the firm to expose itself to harsher corporate governance which enhances its reputation in the financial market.<sup>20</sup>

As stated above; the object of the board is to represent the owner's interests by, among other things, mitigating cost of managerial discretions and self-interest. The main tools available to the board in order to discipline management can be divided into four categories;<sup>21</sup>

- 1) *Requiring board approval of major capital expenditures, acquisitions, divestitures and security offerings.*
- 2) *Controlling the firm's capital structure.*
- 3) *Hiring outside consultants to scrutinize major projects.*
- 4) *Firing the CEO*

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In order to be able to truly protect the owner's interests it is essential that the board has **a)** independent individuals (outsiders) **b)** real power to control manager's self-serving behaviour. The perception of the manager as opportunistic is tightly linked to agency theory.<sup>23</sup> An increase in board independency will subsequently lead to a sharper monitoring of the CEO. As a consequence the CEO will experience a stronger pay-performance relationship.<sup>24</sup>

The level of competition within an industry plays an important role when deciding on the level of monitoring needed. Board independence is less relevant or even redundant in highly

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<sup>19</sup> Buchholtz A. et al (2005)

<sup>20</sup> Oxelheim, L., Randoy, T. (2003)

<sup>21</sup> Ogden et al, (2004)

<sup>22</sup> Ibid.

<sup>23</sup> Hendry, K. et al, (2004)

competitive industries, since the firm is already “monitored” by a competitive product market. Board independence reduces firms’ performances in industries with highly competitive product markets. But independent boards enhance firm performance among companies facing less competitive product markets.<sup>25</sup>

In opposition to the *agency theory* stands the *stewardship theory*; this theory does not believe in the opportunistic manager but instead assumes that the professional manager is driven by “*a need to achieve, to gain intrinsic satisfaction through successfully performing inherently challenging work, to exercise responsibility and authority, and thereby gain recognition from peers and bosses*”. The Stewardship theory agitates for active board but prefers insiders to outsiders since these possess a “deeper knowledge, expertise and commitment to the firm activities”.<sup>26</sup>

## **2.4 Aligning pay with performance**

In order to accurately and fairly award a performance it must be measurable. Performance in most jobs cannot be measured objectively because of joint production and difficulty of observation.<sup>27</sup> Subsequently; individual output is not always quantifiable. Apart from the measurement difficulties there are several other negative consequences with an objective merit system.

- i) Any misspecification of the performance measurement system can be easily gamed by employees.
- ii) The measurement system becomes difficult to change because inevitably any alteration may seem detrimental to some employees
- iii) The threat of increasing objective standards higher in response to better-than-expected-performance this year, causing a behavioural reaction where employees deliberately restrict output so that they can earn their bonuses.<sup>28</sup>

In opposition to the objective incentive system stands the subjective which suffers from different shortcomings. The subjective systems are unpopular due to the fact that employees

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<sup>24</sup> Ozerturk (2005)

<sup>25</sup> Randoy, T. et al, (2004)

<sup>26</sup> Davis, J. H., et al (1997)

<sup>27</sup> Jensen, M. et al, (1990)

<sup>28</sup> Jensen et al (1990)

may not trust superiors to evaluate their performance accurately. Given the negative attributes of objective systems and the lack of trust that defeats the subjective systems a great sense of carefulness must be included when constructing incentive programmes.<sup>29</sup>

Researchers have linked pay to performance using some basic principles. One of these is the rule of keeping the relationship between pay and performance as linear as possible. Generally this is not the case, firms preferring to implement a “kinked” compensation line with a linear relationship in place only in the average or expected line of performance, and with a floor represented by a base salary and a cap represented by salary plus a maximum amount of bonus. A linear pay schedule would in comparison offer a better mapping of the employee’s performance paying out a constant percentage of the value created through her actions.<sup>30</sup>

Bonus payout has also proved to be an effective way of retaining staff. Researcher as well as business practitioners have seen clear evidence of a strong correlation of employees leaving a firm shortly after their bonuses have been paid out. One good way of avoiding this dilemma is to arrange for the bonus to be paid out later in the year, bringing the employee’s attention to the result of the upcoming year. It is important that managers communicate the relation between a bonus pay-out and an excellent performance, fostering a culture of recognition.<sup>31</sup>

Competition between firms for managers induces less risk adverse managers to work for firms where there exist a greater marginal benefit of effort. The manager-selection effect unambiguously increases internal firm efficiency. In a moral hazard framework it is shown that firms competing for managers with different degrees of risk aversion have a greater marginal benefit of effort when implementing payment schemes which induces greater managerial effort and less inefficiency.<sup>32</sup>

A manager in a firm of higher risk should have a compensation that is less dependent on firm performance. Managers are prohibited to speculate in their own firm’s shares. What they can

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<sup>29</sup> Jensen, M., and K. Murphy (1990)

<sup>30</sup> Copeland et al, (2004)

<sup>31</sup> Cox (2004)

<sup>32</sup> Wright, D.J., (2003)



do is to trade in the markets. Studies show that many managers hedge their exposure either by using instruments or simply using a market index<sup>33</sup>.

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## **2.5 Incentives reaching over multiple time periods**

Due to behavioural factors offsetting the effectiveness of standardised goals, these goals should always be relative to expectations. Stretched targets that go for longer periods need therefore be set relative to ongoing expectations.<sup>34</sup>

One-year performance measures should be guided and complemented by a long-term perspective in order to avoid a behaviour that maximises short-term performance at the expense of the long-term strategic and financial goals. There exists two basic tools when implementing multiperiod incentives. **a)** Creating a compensations bank system and **b)** Implementing divergent incentive schemes.<sup>35</sup>

### **2.5.1 Compensation Bank<sup>36</sup>**

The compensation bank concept takes the awarded bonus received by an executive this year and puts it into a corporate trust (or makes it a general obligation to the firm) where it vests to the executive over a period of time. Vesting may be granted by a review board or be automatic over time.

### **2.5.2 Divergent Incentive Schemes<sup>37</sup>**

Top management can directly impact the share price of the company; therefore the incentive structure that is optimal for top management is quite different to that of lower layers managers within the same company. Important when constructing incentives is to oversee that the performance rewarded is accessible and that the manager has a possibility of affecting the result tied to the compensation. Lower-level management incentive pay, also known as gain sharing, has shown to result in productivity gains. The concept of linking employee incentives to value drivers that they can control has shown good results of efficiency.

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<sup>33</sup> Ozertuk S (2005)

<sup>34</sup> Copeland et al.(2004)

<sup>35</sup> Ibid

<sup>36</sup> Ibid

## **2.6 Incentive Design**

A firm is made up by a set of contracts designed with the intent to share risks and maximise output<sup>38</sup>. Taking on the role of residual claimants with a limited liability the shareholders satisfy all other high-priority claimant and accept all residual risk. In order to maximise their own wealth shareholders must therefore take into consideration the wellbeing and prosperity of other stakeholders<sup>39</sup>.

There are three specific questions that must be raised when designing incentives programmes:

- i) How should pay be linked to performance, given the objective of shareholder (i.e. owner) wealth maximisation?
- ii) Given that executives change jobs frequently, how should compensation be distributed over time?
- iii) How should incentive vary between line officers and staff, and as one moves from top management to middle-level management and lower?<sup>40</sup>

Rappaport has developed a theory regarding question i) according to him at least four major factors will induce management to adopt a shareholder orientation: (1) a relatively large ownership position, (2) compensation tied to shareholder return performance, (3) threat of takeover by another organization, and (4) competitive labour markets for corporate executives.<sup>41</sup>

In initial state owners can choose between control and delegation. If the incentive programme is designed before a manager takes output decisions the owner can enjoy the benefit of designing and strategic contract model and take active part in affecting the manager in decisions made<sup>42</sup>.

A great challenge is to construct a contract which ensures that the managers act in the best interest of shareholders. There are different ways to align the interest of shareholders and

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<sup>37</sup> Copeland et al., (2004)

<sup>38</sup> Odgden et al., Advance Corporate Finance

<sup>39</sup> Jensen et al.

<sup>40</sup> Copeland et al. (2004)

<sup>41</sup> Rappaport,A., (1998)

<sup>42</sup> Cavagnac, M., (2005)

management but they all strive for minimising the agency costs of managerial discretion and maximising the firm's stock price. There are two different measures of incentive compensation suggested; (a) a bonus that is contingent on the firm's accounting earnings, or (b) grants of stock or stock options, the value of which depends on the firm's stock price performance. These contracts only solve part of the actual problem. Since the manager is still poorly diversified in comparison, he or she will still be tempted to keep the firm's operating risk to a minimum and to under-employ debt.<sup>43</sup>

## **2.7 Compensational plans<sup>44</sup>**

Compensational plans typically have four key objectives:

1. To align management and shareholder interests by giving managers the motivation to choose strategies and make operating decisions that maximises shareholder wealth.
2. To provide sufficient leverage, as measured by the variability of the potential rewards, to motivate managers to work long hours, take risks, and make unpleasant decisions such as laying off staff or closing a plant.
3. To limit retention risk or the risk that valued managers will bolt for a better offer, especially during industry downturns and recessions.
4. To keep shareholder costs at a reasonable level.

Stock option plans are often used to provide the necessary linkage between performance and CEO compensation. Having no connection between CEO compensation and shareholder value (i.e. stockprice) can cause aggravation among shareholders. Watching the CEO make vast amounts of money whereas the stock or the company are struggling communicates a strange message. Stock option plans have been criticised since they are assumed to begin rewarding managers long before the managers have created any wealth for shareholders. As an alternative a leveraged stock option (LSO) programme has been developed. Here the exercise price rises at a rate equal to the cost of equity capital minus the dividend yield and minus a modest adjustment for the inability of managers to diversify their risk.

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<sup>43</sup> Ogden et al.(2004)

<sup>44</sup> Ehrbar A., (1998)

### **2.7.1 Stock options<sup>45</sup>**

When being granted stock options the manager will be highly rewarded in good times whereas in poor times he will not be punished. Stock options amplify the manager's tendency to misreport. Furthermore, stock options are not protected against dividend payments. This may change the behaviour of management to have a bias against the payment of dividends and in favour of stock repurchases.

Studying the announcement effect of the inception of stock option plans for management indicate that shareholders react favourably, and consider the plan to be a net benefit. Stock option plans are adopted more on account of tax and signalling reasons than to reduce agency cost between managers and owners.<sup>46</sup>

Option programmes should include more detailed covenants and leave restrictions as to which levels of result the firm is expected to fulfil in order for incentives to be paid out.<sup>47</sup>

The exercise price of stock options is often set at the market price at the day when the stock options are granted. On a bull market a manager can earn large amounts of money even if underperforming relative to competitors.<sup>48</sup> In addition to this there are further risks when management is granted stock options; stock option holders share all the upside potential but bears no downside risk, the mandatory holding period of the option is normally very short thus when the manager realizes his gain by selling the options the incentive is diminished.<sup>49</sup>

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## ***2.8 Measurement systems for attaining corporate value creation***

Since inventing the perfect incentive programme would be highly lucrative, many have tried. Worth stating although some programmes have had a larger success than other, it is difficult defining where real value is created and why. We have tried to present some methods that either seems in line with our own personal view on how an effective incentive programme should be structured, adds a different perspective or have been implemented in commercial state-owned firms. To us it has been important to both assemble knowledge on how different

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<sup>45</sup> Burns, N. et al (2006)

<sup>46</sup> Copeland et al. (2004)

<sup>47</sup> Copeland et al (2005)

<sup>48</sup> Rappaport, A., (1998)

programmes differ from each other but also to discuss the ideas of the different views with our respondents.

### **2.8.1 EVA – Economic Value Added 50,51**

EVA is a performance measure, but it is the specific incentives that can change management behaviour. EVA requires incentives to drive desired outcomes since without them EVA can not have any sustained behaviour effect. EVA and NPV yield identical answers when used to value companies. Moreover, since EVA is a measure built on flows, it can be utilised as a device for period-by-period contemporaneous incentive compensation. According to the EVA method shareholders need managers to focus on sustainable improvements in EVA.

To keep managerial behaviour congruent with shareholder needs EVA uses performance measurement and incentive compensation. Fundamental ideas of EVA suggest that instead of using shares or legal title in order for managers to work in shareholders best interest EVA rather uses money held at risk that are lost if improvement in performance is not sustained over time. EVA does not focus on debt in the same way as for instance Private Equity firms. According to EVA the absolute measure to apply is one where an uncapped variable pay is tied to sustainable improvement in EVA. Huge amount of value hidden within firms can be released with help from an implementation of EVA from the top of the organisation to the absolute bottom.

The focus of incentives is recommended to be on EVA drivers, who are drivers that can be controlled, deeper down in the organisation. This method can turn average worker into a value chain agent. According to this theory there is a fundamental problem prior to implementation of EVA. Since the share of fixed pay is too large, the variable pay and incentive pay is too low, capped or none existing. The companies are not effectively run. Instead of focusing on creating shareholder value, management start focusing on size. This is due the positive relationship between firms size and managerial compensation.

EVA-theory states that it is the at-risk nature of variable pay that makes employees truly sensitive to shareholder needs. Therefore every cap is removed. Shareholder interests are

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<sup>49</sup> Ibid.

<sup>50</sup> Steward, G.B. III (1991)

protected through the deposition of the variable pay into a deferred account that can be lost if the gains that created the variable pay is not sustained over time.

### **2.8.2 EVA in state-owned firms<sup>52</sup>**

EVA has been implemented in several firms in newly deregulated areas. Here EVA is used to boost the firms when trying to adjust to new circumstances and heavy competition as opposed to a secure monopoly based situation. EVA has also been used in state-owned firms without privatisation plans and is there used to provide an objective basis for capital investment and pricing decisions. Actually the state owned U.S. Postal Service which is stated to be the greatest EVA success story yet. A common insight when implementing EVA is the firm's insight into the inefficiencies displayed in their use of capital and that the firm has overinvested in one significant way. EVA has been implemented in several Swedish state-owned such as Posten AB, Vasakronan AB and Vasallen AB.

The number of stock options managers receive each year is determined by the size of his or her EVA bonus.

The essential goal of the EVA bonus system, which builds on the objectives, listed above:

- To link performance incentives more closely to increase in shareholder wealth.
- To provide a single focus for operations management, capital budgeting, planning, performance measurement, and incentive compensation.
- To promote a culture of high performance and ownership by management, in which managers take the initiative to create value.

### **2.8.3 SVA – Shareholder Value Added<sup>53</sup>**

SVA created by Alfred Rappaport will, when performed properly yield the exact same results as EVA. This is due to both models using Cost of Capital as the factor that drives the model. SVA is mainly used to determine if an investment is lucrative or not but can also be used as

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<sup>51</sup> Ehrbar, A. (1998)

<sup>52</sup> Steward, G.B. III (1991)

an incentive programme<sup>54</sup>. Rappaport assumes that the most effective way to structure an incentive programme is to:

- 3-5 years horizon when measuring value
- 3-6 qualitative leading indicator of value-creation
- SVA target of performance
- Uncapped bonus
- Bonus bank

Rappaport further states that the most important factor is to reward the manager only for the superior performances which according to Rappaport is a rule generally neglected in most incentive programmes.<sup>55</sup>

## ***2.9 The real key to creating wealth 56, 57***

According to Steward it is of high importance for firms to undertake a system where managerial incentives are based on measures of EVA. The right way to do this is handing the manager a bonus, which represent a certain share of EVA. In this way the managers' interests are aligned with those of the shareholders. The risk of focusing only on earnings, ignoring the long term value creation, can even push managers into manipulating numbers as have been observed in cases such as Worldcom and Enron.

Instead of the repeated negotiations that occur under the regime of budget based bonuses the EVA based bonus is only calibrated once. When implementing the system a certain share of EVA increase is used for determining the bonus pay-out each year. This provides the managers with great sense of possibilities, to feel in control and to have sharp personal incentives to execute aggressive plans and maximise the shareholder value.

In this way bonus is said to drive the budget, instead of vice versa. Steward believes in decentralising decision making since the new financial model emphasises management by motivation and not by mandate. Steward is aware of the risk of delegation and managers may

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<sup>53</sup> Rappaport, A. (1998)

<sup>54</sup> Ibid

<sup>55</sup> Rappaport, A., (1998)

<sup>56</sup> Steward, G.B. III (1991)

<sup>58</sup> Ehrbar, A., (1998)

engage in empire building rather than value creation if left with too much autonomy. To mitigate this he suggests a risk for managers to lose parts of their accumulated bonus if performing mediocre or poor.

## **2.10 Oktogonen<sup>58</sup>**

Jan Wallander, former CEO at Handelsbanken, and a Swedish pioneer when it comes to creating employee incentives. Initiated by Wallander, *Oktogonen*, was introduced in 1973. Coming from a deep crisis Handelsbanken was now rising and according to Wallander this was mainly thanks to the employees. Apart from rewarding the employees the *Oktogonen* concept aimed at finding a way to create a long-term commitment to the bank.

At the end of every year, the bank's Return on Equity is benchmarked to several other Swedish banks. If Handelsbanken manages to surpass the others the residual is inserted into the *Oktogonen* fund. To create the long term commitment the money can not be distributed before the employee reaches the age of 60. To further strengthen the feeling of loyalty the shares are identical for all employees, ignorant of their position. As one of few limitations the deposit into *Oktogonen* can not be more than 25% of total dividends to shareholders. Ever since the system was implemented, with one exception, deposits have been made into the fund which is now the largest shareholder in the bank.

Apart from the monetary aspect of the system it also includes two permanent seats on the board of directors which are reserved for representatives from *Oktogonen*.

## **2.11 MUST<sup>59</sup>**

Oxelheim & Wihlborg suggest that the manager can not control of external factors that do affect the cash flow of the firm. In order to avoid rewarding a underperforming manager that operate under beneficial circumstances and not to punish a overachieving manager operating under harsh conditions the authors want to reveal the true value-creation. Therefore they suggest inclusion of macroeconomic variables when determining the firm's real

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<sup>58</sup> Svenska Handelsbanken – Annual Report 2005



performance. The macroeconomic variables used are for instance interest-rate, inflation, and currency risk and country risk. By developing management compensation schemes based on management's contribution to the firm's intrinsic competitiveness Oxelheim & Wihlborg believe that a more just and effective incentive scheme is created.

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<sup>59</sup> Oxelheim L., et al (2005)

## Chapter 3: The methodology

*In this part of the thesis our methodology is explained and discussed. We will also inform the reader about how we gathered and processed our empiric data. Finally the validity and reliability of the study is discussed.*

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### 3.1 Choosing approach

For this master thesis we have chosen to employ a *abductive* approach and started our work by performing a thorough examination of literature on the subject. The aim of our research was to determine if the incentive programmes used in commercial state-owned firms in Sweden are effective according to contemporary theory. Since this is a widely debated subject we have tried to gather different views when choosing respondents for our personal interviews. The usage of an *inductive* approach was denied early on because we certainly felt that a theoretical knowledge would be valuable when performing the interviews. We assumed that a deductive approach would enable an analysis of similarities and differences among views of our respondents and the theoretical context created by us. To us, the most important was to understand and to analyze, why or why not the incentive programmes agitated in theory was used in commercial state-owned Swedish firms. The theoretical approach would also help us when developing a more effective incentive programme to use in the examined firms.

### 3.2 Data gathering

When performing research there are basically two different research methods to choose from; the *quantitative* method which presents numerical results, whereas the *qualitative* method presents how the respondents being interviewed or observed are positioned towards the subject<sup>60</sup>. We believe that the qualitative method would fit our research more properly since we have tried to observe and to expose the rationale behind the incentive programmes and ways to improve them. This makes our thesis *hermeneutic* since it is based on reason<sup>61</sup>. A central matter was the ability to collect opinions and values expressed by our respondents. It

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<sup>60</sup> Johannessen, et al, (2003)

<sup>61</sup> Lundahl, et al (1999)

is a common matter that quantitative method is used together with a deductive approach. This is done in order to obtain an accessible result presented with numbers. Even though the inductive approach may be regarded as more hermeneutic than the deductive approach, which may be regarded as a more positivistic and natural scientific approach, we have chosen this specific combination of approaches. Regarding the structure of our aim with the thesis we strongly believe that this is the best method. Since the thesis is based on reason we feel that a quantitative research would risk leading to deceptive results<sup>62</sup>.

### **3.3 Data selection**

#### **3.3.1 Primary and secondary data**

As mentioned above we have had a qualitative focus when gathering our data. We have worked with primary as well as secondary data and both have been important in shaping the final product. Below we will expose residual choices made when gathering and selecting the data.

Our definition of primary data refers to the data that we personally gathered for this specific thesis. Secondary data is defined as data collected from prior research not directly linked to our study. We have operated by comparing our secondary data- the theory to our primary data- the empirics.<sup>63</sup>

Considering our secondary data we must stress that it was initially produced for different studies with different intentions than our own<sup>64</sup>. In some of the cases our insight in the research methodology used for these studies have been limited which has raised the question of reliability of the information when using it for this specific thesis.

#### **3.3.2 Critic of sources**

The respondents used in our study were chosen before others for different reasons. Since the subject chosen has been debated in the media some persons are chosen because they have

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<sup>62</sup> Bryman et al (2003)

<sup>63</sup> Lundahl, et al (1999)

<sup>64</sup> Ibid

previously agitated their opinions publicly. Others are chosen because of their position rather than their opinions. Important to keep in mind is that these individuals are expressing their own subjective views in all cases, and the relative interest and importance of these can naturally be questioned. We do feel that the diversity of the respondents provides good spectra of different opinions which enable an objective thesis.

### **3.4 Interviews**

#### **3.4.1 Standardized and unstandardized interviews**

Lundahl and Skärvad defines *standardized* interviews as interviews, where a questionnaire is followed closely and *unstandardized* interviews where the interviewer lets the interview shape itself by adjusting his questions to the specific situation<sup>65</sup>. They also introduce a third method which they refer to as *semi-standardized* where the questions are pre-decided but the respondent is urged to develop his answers. This is done through relevant additional questions posed whenever the interviewer presumes that they can add additional depth to the interview. We categorize our own method as *unstandardized*. They are *unstandardized* although the respondents have been aware of the topic and boundaries in advance of the interviews we believe them to be *unstandardized*.

#### **3.4.2 Structured and free interviews**

Lundahl and Skärvad also defines the difference between *structured* and *free* interviews where the prior is characterised by the interviewer having a clear purpose of the interview and that the interview follows a certain systematic order and is focus towards information. The latter is characterized by a broader focus. The interview is designed to create an understanding of the values and opinions of the respondent rather than pure facts<sup>66</sup>. Our interviews have not been good examples of either of the two but contain fragments of both. The interviews have been oriented towards facts but it has been equally important to identify differences between the views of the different respondents. We have let our interviews consist of the *structured*

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65 Lundahl, et al (1999)

66 Ibid

interviews orientation towards facts at the same time as we wanted to use the free continuation of the free *interviews*. Thus, one important task have been to interpret opinions and values of the respondent. To obtain this we used *open process questions* – which do not include any given alternatives of answer<sup>67</sup>.

### 3.4.3 Personal interviews

Interviews can be categorized in different ways; either as *personal interviews*, *telephone interviews* or *surveys*<sup>68</sup>. We have performed six personal interviews which did not follow a pre-decided structure. We chose not to include surveys into our research since we believe that the depth needed to cover this subject would not be captured in a survey. Well in advance our respondents were e-mailed a shorter presentation of our topic as well as a few subjects for them to think of before the interview. When the interviews started the respondents were aware of what we wanted from the interviews which made the interview run smoothly. Most of the interviews came to be a presentation where we would fill in more specific questions. This led to a more open discussion which we believe took us further than a stricter interview could have done. As interviewers we had to be well prepared both concerning the subject in general but also regarding the specific knowledge and views of the respondent. Being well prepared enabled us to pose adequate additional questions ensuring thorough answers. Our feeling regarding the spontaneous additional questions is that those provided a higher level of sincerity by catching the respondent more off guard which was the purpose.

When performing the personal interviews both of us were present which we felt was a prerequisite to enable a mutually interesting debate with the respondent. Apart from that it also created better fundamentals when producing the empirics as well as the analysis. Some methodology theory stresses the disadvantage of being more numerous than the respondent. Although we took this under consideration all the respondents were experienced professionals used to expressing and agitating their personal views in interview-like situations.

The interview sessions were all started by us telling the respondent about our work and our finance studies in Lund. This was made to create a more personal atmosphere which we hoped was beneficial to the following interview.

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67 Arbnor et al (1994)

68 Lundahl, et al (1999)

### **3.4.4 Telephone interviews**

Two additional telephone interviews were performed. The approach was initially identical to the one used for the regular personal interviews where the respondents were aware of the purpose of the interviews. After having scheduled a date for the interviews we e-mailed the same material as for the regular personal interviews. When performing the telephone interviews we used a speakerphone enabling us both to listen to the respondent. The main difference was that only one of us interviewed the respondent since we felt that a conference call could be both noisy and confusing to the respondent. Consequently the interview was probably not as vivid as when we both interacted in the discussion.

### **3.4.5 Documentation of the interviews**

During the interviews one of us played the role of the head interviewer whereas the other was mainly although not solely in charge of taking notes. After having finished an interview session we immediately sat down together to assemble our notes, impressions and opinions. This method worked well and we believe that we captured the essence of the interviews at each time. In advance we were uncertain whether to record our interviews or not. Since the subject is widely debated and even infected and our respondents expressed anxiety of misinterpreted quotes we assumed that they would act more cautious if being recorded.

### **3.4.6 The interviewer effect**

The primary data gathered by us risks being affected by the *interviewer effect*<sup>69</sup>. The interviewer effect can be divided into two fields; effects related to the questions we ask and how we ask them-which have been covered earlier in this chapter but also how the respondent feels about our personal behaviour and comportsment.<sup>70</sup> The respondent may also be affected if he has an opinion of us prior to the interview. In this case our previous contact with the respondents has been limited to the initial contact taken to schedule the interview and sometimes not even that. Consequently this could not have compromised our research in any way. The personal interviews have been performed in conference facilities situated in connection to the offices of the respondents. We assumed this to be beneficial since the

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69 Arbnor et al, (1994)

70 Bryman et al,(2003)

interview did not interfere too much with their work and took place in their location of choice instead of for instance a location neutral to both parties.

At all times we met with only one person. The persons had different backgrounds as well as current professional positions. The important factor to us was to, in advance, ensure that we met with a person possessing rare knowledge on this specific topic. We have tried to keep away from all negative effects that can lower the quality of the interviews and by doing this we hopefully minimized the potential effect. We have also maintained a critical view versus new and unknown information and handled our material with the greatest concern.

### **3.4.7 Limitations in the interviewing material**

During the interview sessions we got the impressions that the respondents spoke quite openly and gave us access to documents normally not distributed externally. However this was done with the instruction not to reproduce material and to promise to seek approval before using direct quotes. This request was naturally granted and we have let all respondents read and comment our empirical chapter. In this way we hope to avoid respondents feeling misinterpreted or left-out.

## **3.5 Presentation of the respondents**

### **Håkan Bryngelsson – CEO Vasakronan**

Håkan Bryngelsson has been with Vasakronan since 1996 which makes him one of the most experienced CEOs in the state portfolio. Apart from Vasakronan he been the CEO of firms such as LIC Care AB and Mekator AB. Håkan has a vast knowledge and experience from working with corporate governance related issues during his years with Vasakronan, Economic Value Added has both been implemented and abolished. An examination by turnover makes Vasakronan one of the largest fully state owned firms. Håkan also represents the view of Föreningen Svenskt Näringsliv (Confederation of Swedish Enterprise) where he has been a member of the board for a number of years.

### **Mats Ström –Vattenfall AB**

Mats Ström represents the largest state-owned firm; Vattenfall AB. Vattenfall has a vision of being the leading European company in the energy field. At present Vattenfall is at the right track to forthfill the ambition since Vattenfall is currently one of the top three. Vattenfall is often said to act even more ruthless than private firms when it comes to aggressive expansion

through, for instance acquisitions. Mats Ström is internally responsible for the incentive programme that includes all employees except for the CEO. Mats Ström is the single employee at Vattenfall with the deepest knowledge in these matters and has been with the company for nearly thirty years.

### **Marianne Förander – Industry Ministry**

Marianne Förander deals with issues concerning state-owned firms on a daily basis in her position at the Industry Ministry. She has been with the department for several years and is known to hold an expertise in the field. She is politically untied and is currently representing the state on the following boards: Akademiska Hus, Specialfastigheter AB, Vasallen AB.

### **Mats Qviberg – CEO Öresund AB**

Over the last years, Mats Qviberg has become a very publicly known character. Not only is he the CEO of Öresund AB but also co-founder of fund commission Hagströmer & Qviberg and a holder of several membership positions on various boards. Mats Qviberg has an highly exclusive insight into corporate governance matters since he is currently both a large shareholder, board member and CEO. Mats Qviberg is often invited to give speeches or debate corporate governance. He contributes not only with his knowledge but also as a representative of the private sector and their view on incentive programmes in general as well as incentive programmes in public firms.

### **Lennart Zadig**

Lennart Zadig currently works as a management consultant with an expertise in issues concerning incentive programmes. He is a former CFO of LIC Care AB which was the first Nordic company to implement EVA in the early 1990's. For six years Lennart Zadig worked together with the American consultant agency Stern Steward and he was in charge of the EVA implementation in among others Vasakronan AB and Posten AB. Lennart Zadig's knowledge goes beyond incentive programmes and reaches into the actual issues dealt with in commercial state-owned firms.

### **Leif Rytter – CFO Vasallen AB**

Leif Rytter represent Vasallen AB which was founded in 1997 and jointly works with Swedish municipals (kommuner) restoring and improving old buildings owned by the national defence to sell them on commercial terms. The employees of Vasallen are currently



involved in an incentive programme and Leif Rytter is one of the head designers behind the specific programme.

**Gunilla Winlund – vice president human resources**

Gunilla Winlund represents V&S Group which is the second largest wholly state-owned firm still using incentive programmes for their employees. Gunilla Winlund has been with the firm for a number of years and offers, besides information concerning the contemporary status, a historical perspective regarding the incentive matter.

**Sven-Erik Sjöstrand – professor SSE**

Sven-Erik Sjöstrand is a professor in Business Administration on Stockholm School of Economics. Sven-Erik has been researching corporate governance for a number of years and has published several articles and books on the subject. Apart from the input gained from numerous years in the academy Sven-Erik has also been on a number of private boards and he has attained an understanding for both the theory and the practice. Only this year Sven-Erik has appeared more than once on television documentaries sharing his views on management incentive programmes and bonus payouts.

### **3.6 Validity and reliability**

A research study characterized by a high rate of validity is one of high integrity and without any systematic measurement mistakes.<sup>71</sup> We have chosen to analyze the validity using two subtitles; *internal* and *external validity*.<sup>72</sup>

The internal validity examines whether the instruments of measurement utilized by the researcher measures what it is supposed to do.<sup>73</sup> We believe that our internal validity is high since we have had a good and thorough contact with our primary sources who have been well informed regarding their role in our research. The respondents used for the personal interviews were chosen through *intensive selection*, which according to Johannessen and Tufte is characterized by the researcher choosing respondents who are initiated but not to an extreme extent.<sup>74</sup> Our respondents clearly possess great knowledge in the field although not the extent where they risk losing the possibility to be objective. The internal validity is normally high when it comes to qualitative research, assuming that the researchers have had the opportunity to speak to the respondents and perform an adequate selection process.

The external validity on the other hand measures the reasonability of the results as well as the research performance itself.<sup>75</sup> A perfect external validity or good reliability means that if the research is repeated by a different researcher or on a different phenomenon, it would still yield the same result.<sup>76</sup> To increase our external validity as well as reliability we have tried to obtain a good overview of the topic as well as choosing adequate respondents. If we would have, for instance interviewed only respondents from management teams our conclusions would not be representative for the view of all parties.

According to Johannessen and Tufte reliability can be examined through two different methods; either the *test-retest reliability* or the *inter-rate reliability*.<sup>77</sup> When utilizing the test-retest the research is repeated again in a few weeks. This method was not relevant to us since we have performed a qualitative study. We are certain that our views and regards would not

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71 Lundahl et al (1999), Bryman et al (2003)

72 Johannessen et al (2003), Lundahl et al (1999),

73 Bryman et al (2003), Arbnor et al (1994), Lundahl et al (1999),

74 Johannessen et al (2003)

75 Bryman et al (2003), Arbnor et al (1994), Lundahl et al (1999),

76 Johannessen et al (2003)

77 Johannessen et al (2003)

have been changed if repeating the study. If instead we would have mailed a survey to a large amount of respondents a test like this would feel more meaningful.

The *inter-rater test* on the other hand means that the same study is performed simultaneously by several researchers or research teams. We have not had the opportunity to use this test, but we believe that if different researcher would have performed the study using the same respondent, they would surely have ended up with roughly the same results. We do not believe that our approach when it comes to methodology or examination neither our personalities have affected this study enough to obtain unusual results.

## Chapter 4: The empirical study

*The empirical section will commence with an orientation of the Swedish aspects on incentive programmes in private as well state owned firms. Thereafter we will display the respondents' views on management compensation and incentive design and the governing aspect associated with this.*

### **4.1 Swedish Aspect on Incentives<sup>78</sup>**

The year when incentive programmes were the most extensively implemented was in 2002 when the share of companies holding incentive programmes was 79 %. In 2005 52 % of listed Swedish companies had incentive programme. Although a smaller percent of firms implement incentive programmes today than in 2002 there exists a trend where incentives are growing in popularity with a rise of 7 % from 45 % of companies implementing programmes in 2004.

PWC view this as a reaction to the strong market and decreasing scepticism against incentives among the public. The numbers of companies employing value-based incentives are decreasing, this is said to be an effect of the massive deployment of programmes during the period of 2000-2002 and the limited renewal of these.

PWC also note that type of programmes preferred have differed over the years. During 2005 stock programmes grew in popularity especially the stock bonus programmes. The number of programmes restricted to top management not including everyone working for the firm also grew.

### **4.2 Facts from state-owned firms<sup>79</sup>**

The ambition of the government is to assemble boards of high competence within the specific fields adequate for the different firms. Not only referring to the current state but also with respect to future challenges. The board members should always bear firm's best in mind but at the same time also have high personal integrity and be the role model expected from a person

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<sup>78</sup> PWC study (2005)

<sup>79</sup> Annual report of state owned companies (2004)

representing the Swedish state. Approximately 40-60 new members are annually assigned to the different boards and consideration is also to be taken to background and sex. To increase the share of female board members have been an ongoing ambition and the current status is 43%. The average age for a board member is 53 years. To enforce active and updated boards they are held quite small at an average of 7,6 members which are supposed to remain members for a maximum of 8 years.

The most important task assigned to the board of directors on these commercial state-owned firms is to hire and fire the company CEO. Since independency is considered utterly important only one member of the management team, however **not** the CEO, is allowed on the board of directors. The board members are also to supervise the ambition to act with special concern towards the environment, social issues, equality between the sexes and ethics. In the cases where the state only partly owns a firm the aim is to maximise the communication of goals in order to try to affect fellow shareholders.

*State policy on management compensations:*

- Compensations as well as benefits should be competitive and in line with those of peers. State-owned firms should never have a higher base of compensation compared to peers.
- Fixed compensations and retiree agreements are preferred.
- In particular cases when incentive programs are being implemented these should involve the entire workforce, except the CEO who is always excluded. There should exist a direct connection between the individual incentive goals and the overhead firm goals. When structuring an incentive program no external factor that could affect the compensation may be included. The maximum incentive allowed to be paid out is the worth of two month salary. The state considers a variable salary equal to bonus payout.

### **4.3 Primary data**

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*Our in-depth open question interview approach has given us the opportunity to find and capture further argumentations and study the underlying thoughts of our respondents.*

#### **4.4 The role of the Board**

*All our respondents agreed that the main focus of the board is to ensure that the management obeys the wishes of the owner. The respondents however differed in their opinions concerning to what extent this should include the usage of incentive programmes. They also expressed deviations in convictions and opinions when it came to exposing the board itself to incentive-based compensation/ variable pay or not. This section aims to display the congruence and the discrepancy of the respondents interviewed.*

When appointing a board for a state owned firm the industry ministry takes a recruitment profile into consideration. This focuses on objectivity, equality (42 % are women) and diversity of competences rather than experience from working as CEO, which is often the case. The profile help state owned firms to avoid packing the board with stereotypical board members (white, male, aged 50-60+).

Marianne Förander concludes that the number of board members representing the owner is of secondary importance due to the fact that all members of the board carry a responsibility of acting in the best interest of the owner, regardless whether they hold an official position with the industry ministry or not. There is always one non-political expert representative from the Industry ministry representing himself when attending board meetings. The boards in state owned firms are kept quite small, normally around 7-9 people. This is, according to Förander, in order to force all members to be active and involved.

Sjöstrand states that an effective board is of great importance for the success of any company. His main definition of effective is independence. The board should hold a strong position and challenge the CEO and one important aspect of this is that the board must possess complementary information channels and not rely solely on the information provided by the CEO.

Qviberg says that the primary function for the board is to play a supportive role backing up the CEO in an ongoing collaboration. Accountants together with board and management must be presumed to collaborate in the aim of securing that business is handled in a correct and legitimate fashion. Monitoring should be considered being of secondary importance since management is presumed to obey the laws and always consider the financial press and other media.

Winlund stresses that the CEO is under a lot of pressure since being monitored by the board of directors. The board are important when it comes to offering the CEO their expertise, knowledge and coaching. She believes that the board of V&S is exceptionally good compared to boards in other state-owned firms. Private firms are very thorough when appointing board members. This can also be true for the state but some people are surely appointed because of their political expertise. The times when what the firm really need is a business expert this clearly suboptimal.

Bryngelsson states that the performance of the CEO is guaranteed to be up to standard with the help of long term goals set up by the board every five years. This is on top of the regular monitoring and budgeting connected to board meetings held 7-8 times/year.

According to Qviberg a large personal stake in the company should be an automatic term for taking place on any board. Qviberg identifies this to be the single most effective way of aligning board and management with the interest of owners. In addition it also signals a strong belief in the firm that management and board are set to run.

Ström stresses that it important to ensure that the gap between board and management compensation is kept relatively stable. In example the board of Vattenfall include members whose compensations are benchmarked with regards to CEO compensation. Zadig takes this one step further advocating that the board should get variable compensation.

Sjöstrand believes that the strongest and most effective tool to govern and ensure that management is carrying out the intentions of the board is through an ongoing dialogue between the chairman and the CEO of the company in question. This guarantees a higher level of flexibility than any incentive program.

## **4.5 Incentive programmes**

*This section aims to shed light on the respondents' views and attitudes towards the implementation and design of incentive programmes in state owned firms. At the same time we aim to assess what components are preferred in the construction of incentive programmes. We also wish to identify the attitude towards and the drivers behind implementation of incentive programmes in firms in general and in state owned firms in particular.*

Sjöstrand believes that Swedish business life post World War II has experienced an import and implementation of American management theory and practice. Cultural aspects make the acceptance larger for differences in compensation in the US. The American culture stands for much of what incentive programmes signal which makes the propensity to regard positive aspects larger in the US. Sjöstrand does not see any reason to spend money on incentive program only doing one thing, namely making executives wealthy. He regards the programmes as a, although widespread, business trend which he as a researcher can not embrace. Sjöstrand states that incentive programmes only enrich a limited group and must therefore be monitored and investigated thoroughly. He also stresses that it is expensive to construct, maintain and administrate incentive programmes. Sjöstrand does not believe that certain individuals possess extraordinary skills that motivate extraordinary compensations.

Bryngelsson on the other hand views incentive programmes as an effective way to emphasise certain relevant business processes during a short period of time, highlighting the primary issues for a specific year and firm. Bryngelsson adds that in order for incentive programmes to be effective they have to be monitored and revised on a regular basis. Bryngelsson is convinced that incentives are necessary in order to achieve excellence and receive total commitment from staff and management.

In addition to this Ström says that it is important to regard the increased sense of loyalty attached to the implementation of incentive programmes. He believes that there exists a direct correlation between a superior result for the company and excelled wealth for employees.

The largest benefit of incentive programmes is that they stimulate competitiveness within the company. Bryngelsson views internal competitiveness as vital and an important source of



value creation. An incentive program may also be an important part of a firm's image and brand when recruiting top-executives according to Bryngelsson.

Rytter states that Vasallen uses its incentive programme to motivate the employees in to being cost cautious. Sound business is rewarded. But the incentive programme is also tied to the balance sheet in order to disable manipulations of the system. Rytter does not think that the incentive programme makes a great difference on the profit of the firm although he believes that it is important to share extraordinary profits with the employees and an act of symbolism. Qviberg concurs to this by stating that incentives containing monetary bonuses will always make a job seem more attractive since people compare their compensation with each other.

Winlund does not believe that absence of large monetary incentives automatically make V&S a less attractive employer. Only in 2006 two new key employees have joined V&S both coming from private firms where they used to enjoy much larger incentives.

Sjöstrand is cautious when discussion whether incentive programs are an effective tool or not, he is sceptical towards the general soundness of incentive programmes. He lacks enough proof to conclude that they are the one or the other. But since they have not been proved effective to a scientifically satisfactory degree, Sjöstrand views the restrictive guidelines recommending to refrain from incentive programmes as healthy.

## **4.6 Managerial Compensation**

*In our theoretical framework we described the importance researchers put in incentive programmes being individualised and based on variables that are visible and reachable for the employees participating in the program. This section sums up what our respondents perceive as the most relevant aspects when setting the frames for managerial compensation. The recommendations of the Industry ministry exclude the CEO from taking part in incentive programmes. This is due to the fact that the CEO is thought to have an unprecedented ability to affect the result of the company.*

Qviberg states that excluding the CEO from an incentive programme is ridiculous. The fact that the CEO holds a position where he can affect his firms' result automatically makes him eligible for incentive.

Bryngelsson also believes that it is important that the incentive programme should include the CEO. Due to the fact that he is the owner's primary tool to run the company and implement the owner's intentions. Bryngelsson further believes that the CEO should have a different incentive programme than the rest of the staff. The CEO's program should have a sharper focus and be more closely related to the intentions of the board. The rest of the staff should carry incentives linked to business processes.

Zadig states that a CEO-compensation always should be partly made up by an incentive driven variable pay. It is important to make up a total compensation with variable pay. The CEO-compensation takes off from a base amount and is then complemented with regards to the performance of the CEO dependent on his ability of adding value to the owners. Zadig recognizes that difficulties may arise in the transition phase going from fixed to variable pay due to an increased level of insecurity. This must be held in regard when communicating the consequences of implementing a new incentive programme.

Zadig is convinced that the likeliness for the CEO to take on risk i.e. through implementation of innovations increases with a higher degree of variable pay. The CEO will focus his efforts towards innovation and progress actively trying to implement riskier policies in order to create value.

Qviberg concurs by stating that an incentive programme will make management less risk-averse and is therefore positive to the development of the company. Qviberg believes that companies should look friendly upon risk since it means an increased possible up-side.

Winlund says that she believes that it is very inconsistent to exclude the CEO. Normally one would think that the CEO would be the first one to include. But she adds that she does not believe that the CEO of V&S has got a problem accepting the owner's will. She does not believe that being excluded will affect CEO performance because if the CEO does not maximize the value he will be gone sooner or later.

Rytter fears that if the CEO is excluded he/she will lose interest in the programme which in turn can lead to the abolishment of incentive programmes in the long term. Since the incentives are quite modeste he does not think that the CEO has a different attitude compared to if he would have been included in the system. Although excluded from the ordinary incentive programme CEO can still receive gratifications as a reward for a job well done is but. According to Rytter this exists among private as well as public firms.

Sjöstrand believes that a CEO should be compensated with a substantial salary but it should be made up by a fixed pay and not be driven by incentive programmes.

Ström sees the exclusion of the CEO from the incentive plan as an error of thought. According to him this it is based on the notion that the CEO sets the long tem goals and intentions of the firm, when these are in fact set by the board. Ström believes that the result of the CEO not taking part in the incentive programme have increased the salary since it was renegotiated and raised when the new guidelines were presented.

Bryngelsson identifies the major drivers behind bonus programmes and executive salaries as status, competition and ego. Bryngelsson exemplifies by referring to the last step on Maslow's staircase, the CEO wants a high salary in order to realize himself.

Qviberg states that greed is an important and sound source of urge and driver in business; companies setting caps on their bonus-payouts reduce this factor. Therefore incentive programmes should never be capped.

#### **4.7 Incentive design**

*When implementing an incentive programme there are numerous ways to structure it. We therefore asked our respondents to present their thoughts and views concerning the design of an incentive programme.*

Qviberg states that the best way to incentivise management is to turn them into stakeholders through an investment in the company. According to him stock options can be a good way of

creating personal stakes if the CEO lacks personal funds to invest in the firm. Incentives and options should keep the CEO on his toes but not make him sleepless at night.

Winlund believes taking a personal stake in the firm is good but she also recalls the eighties when people literally lost everything they owned including their jobs during financial downturns.

Bryngelsson does not believe that it is a good idea to hold on to one single program for a long period of time because of the risk of manipulation. In order to function as motivation, the goals of the programme should be high set but not impossibly difficult to reach.

Winlund herself is not sure of whether the current incentive of V&S is really effective considering that it is quite small but stresses that her co-workers seem to like the idea of getting additional “vacation money”. It can be regarded as an affirmation that you made achievements

Sjöstrand believes that the business life would benefit from including more idealists that are interested in developing their firms in the best possible way as opposed to people only seeking short term monetary rewards.

Zadig states that an incentive programme should include all employees working within the firm. However it is important that the incentives are weighted with consideration taken to the employee’s ability to affect the result of his/her business unit. In addition to this Zadig reminds that as long as the management is only rewarded when shareholder value is created it is certain that the owners are not put in a disadvantageous position.

If the company insists on having an incentive programme Sjöstrand believes that it should be constructed in a way that makes the whole organisation beneficiaries. SHB is a good example of a long-term incentive program involving the whole firm through Oktogonen.

If the incentive programme of Vattenfall was to be terminated, Ström believes that there could be a risk of Vattenfall losing pace. By augmenting their fixed pay this potentially might be avoided. Ström believes that an abolishment of caps within the incentive program would lead to a sharper focus on the value creating processes and that this would show through improved results. Zadig also agitates uncapped incentive programmes although he thinks that a

“practical cap” can be included. This is done by structuring the incentive programme in a way that makes bonuses over a certain level highly unattainable. This practical cap can also be a way to communicate soundness of a certain system to the public.

Vasakronan's current incentive programme focuses more on raw multiples than the former EVA system with higher level of sophistication. The benefit of the current program is that it is easy to communicate. In the current system the CEO salary is fixed regardless of how the company performs. The current incentive programme is capped and the employees can receive a maximum of two months salaries in bonus.

Qviberg states that incentive programme should as far as possible be individualized to meet the specific needs of the company. If these measurements are too hard or too costly to attain, the company stock is a good and fair substitute. According to Zadig the incentive programme will also benefit from the inclusion of some subjective measurements such as consumer satisfaction and quality of goods and services provided. These are crucial in the long term value adding process.

Qviberg believes that private equity will continue to increase its power and presence driven on by the increasing privatization stock markets are experiencing. An easy way to avoid this is making management become stakeholders. Qviberg adds that there exists a risk that the Swedish stock market might lose in power and importance but at the same time he believes that there will still be many companies interested in being publicly traded. Qviberg adds that the stakeholder perspective becomes increasingly interesting when taking the strong emergence of private equity funds under consideration.

## **4.8 Measurements**

*In this section we will present the respondents' beliefs concerning which method of measurement for value creation that should be employed in order to attain an optimal result. There are numerous measures that may be taken into account when evaluating the performance of employees. In order to be optimally effective the measures should correspond well with the intentions empathised by the owners. Our respondents concluded that an adaptation of the measurement to the group measured is essential. An incentive program is a management tool that should bring the company together rather than cause distrust.*

Zadig promotes, backed by his vast experience from constructing and consulting firms in the implementation of incentive programmes, that Economic value added (EVA) holds many excellent features when it come to measuring management performance. Zadig provides numerous examples where the implementation of incentive programs based on EVA has led to an enlightened economic consideration for the company as a whole.

EVA is hard to manipulate for single employees. Any valuation of an EVA based incentive programme should be performed by objective and independent outside parties. External institutes make out Chinese walls, when measuring for instance customer satisfaction. When using qualitative goals Bryngelsson believes it is best to get outside help avoiding unnecessary biases and securing objectivity.

Zadig concludes that the major benefit of EVA is that it puts management in an owner like position without demanding them to take a personal stake. This is an especially beneficial solution when it comes to entrepreneurial firms with little incentive of dividing ownership. The fact hat EVA has not been implemented or has been removed from state owned firms depends on the political rationales rather than business according to Zadig.

Sjöstrand discusses firms that have made obvious miscalculations when constructing their incentive programmes consequently paying out vast amounts of money to underperforming executives. According to him these miscalculations are derived from too complex incentive programmes implemented by consultant lacking sufficient expertise. To Sjöstrand both EVA and SVA are ambitious programmes but he is not convinced that they truly create shareholder value.

All of our respondents seem quite familiar with incentive systems such as EVA and SVA. Some of the respondents have personal experiences from using EVA and they naturally possess more knowledge but were also more positive in general. However, EVA was in their eyes not enough transparent and comprehensive and this might be why it is now replaced by simpler programmes.

## **4.9 Considering Macroeconomic effects**

*In this section the respondents present their views on whether to filter away macroeconomic fluctuations when constructing an incentive program and to which degree this is done in state owned firms today.*

Macroeconomic fluctuations should naturally be taken under consideration in the day to day job of running a company when for instance hedging interest-rates according to Bryngelsson. However if a firm adjusts its incentive program for macroeconomic fluctuations it runs the risk of missing its core values.

Zadig believes that there would be difficulties if and when macroeconomic fluctuations are taken under consideration. The most apparent difficulty is the fact that the CEO might disregard macroeconomic factors that work to his disadvantage. Zadig therefore concludes that the firm is safest not taking away any macroeconomic effect on the firm's result.

Macroeconomic fluctuation are considered and dealt with upon occurrence, fluctuations are not considered when making bonus-payouts. In addition Sjöstrand says that it is hard to get rid of macroeconomic factors affecting the outcome of a firms return, exemplifying with the weather aspect affecting sales of beer and ice cream producers.

## **4.10 State vs. private owner's perspective**

*The new guidelines concerning compensation of employees in state owned companies came as a direct reaction on the ongoing debate concerning the former management of insurance company Skandia enriching themselves at the owner's expense. This section aims to derive how the respondents believe state owned firms are affected by their unique ownership in general and how incentive programmes in state owned firm are affected by this in particular.*

Sjöstrand believes that state owned companies are more effective than companies with a more diluted ownership structure. A private firm with one single owner with a large personal stake is optimal. A problem that occurs in state owned company boards is that the members do not have a personal relationship to the company. Sjöstrand also identifies a possible risk for state

owned firms to make political considerations rather than business considerations when for example deciding where to locate the companies.

Bryngelsson believes that the state is more long-term oriented in its ownership and governance of companies. Bryngelsson thinks that the financial restructuring plan implemented by Vasakronan post IT-bubble would not have been possible if the company were to have been publicly listed and traded, due to the high frequency of transaction which would have been difficult to convey to the stock-market.

Rytter thinks that there are certain factors that you have to mind if you are a state-owned firm but at Vasallen everything is nice and tidy. Rytter believes that the management team would have presented roughly the same views on the incentive programme even if privately held, but the remarks from the owners would most definitely have been different.

Zadig believes the state owned firms are signified by making dual considerations not necessary focusing solely on the business aspects. State owned firms can also be considered more risk averse due to a sharper monitoring from media, parliament and government. State owned firm also have an incentive to stay in front when it comes to political reforms concerning socioeconomic representation.

Winlund believes that if V&S would have been a private firm the incentive programme would surely have been revised. Firms normally benchmark toward the competitors and in this particular case peer offer around 25-30% variable (bonus) pay. Winlund also thinks that other incentive devices such as option schemes could be included if the firm was sold out.

Bryngelsson identifies much of the state owned firms as investments of an infra-structural nature. V&S Group is driven by political ambition but at the same time they receive a substantial amount of their earnings from exporting liquor.

Bryngelsson further believe that state owned firms are signified by lower short-term payouts but possesses a higher potential of creating long term value. Exit is not an option in the short run for a state owned firm since it is a decided by the parliament. By the same distinction it is hard to view the state owned companies as a sphere where money can be transferred between the different companies.



The firms are allowed to refrain from paying dividends without asking the parliament, but they can also be instructed to increase dividend-payouts. Bryngelsson believes that increasing pay-out is very dangerous considering the effect it may have on a firm's rating. In the case of Vasakronan it is not likely that they can increase their payout rate considering their financial restructuring plans and the general volatility of the real-state business calling for large reserves.

Förander does not view state owned firms as being run differently compared to their peers. She does however identify a more long-term mindset meaning not focusing as much on quarterly results as in the private sector. Förander also believe that state owned firms have an incentive to react quicker to and be better at employing reforms, e.g. reforms with the aim of increasing the representativeness of women and people with non-Swedish backgrounds.

Bryngelsson says that the ongoing debate about incentive programmes is much due to the fact that it is election year and that the government is eager to take a stand against high salaries for corporate executives.

Sjöstrand also raises an ownership perspective arguing that diluted and institutionalised ownership leads to weaker monitoring of the CEO. Sjöstrand points out that monitoring is much stronger and therefore more effective in firms with large and strong stakeholders.

## **Chapter 5: The Analysis**

*In this chapter we will compare our theoretical framework to the empirical material. The comparison will follow the same outlining as that of the empirical study. Whenever we use the term theory we are referring to Chapter 2 in this very thesis – the theoretical framework.*

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### **5.1 Swedish aspects on incentives**

There is no theoretical rationale behind the decrease in employment of incentive programmes in Sweden over the last few years. According to for instance EVA theory all organizations can benefit from using their system in the firm's value-creation process since it is said to release hidden values. A negative aspect judging from EVA theory is the fact that many newly implemented incentive programmes do not include the organization as a whole. This is imperative in order to find all hidden values. Instead only top management is concerned which is proven to be sub-optimal. According to agency theory management is most important to include since they are responsible for the costs of managerial discretion which incentive programmes seek to mitigate. An alternate solution could be to implement divergent incentive schemes as suggested by Mitchell et al. They argue that a distinction is necessary since overall incentive programmes are too complex to be fully communicated to employees below a certain level. The number one priority according to Mitchell et al is to construct incentive programmes where the employees concerned can affect the outcome of variables included in the programme.

### **5.2 Incentive programmes**

According to Coles et al incentive programmes can provide managers with motivation to choose strategies that for instance includes taking on additional risk. Discussing this thought with our respondents their views are inconclusive. While some believe that managers are under such harsh monitoring and pressure that they are performing at their maximum capacity regardless whether incentivised or not others disagree and do perceive a change in managerial behaviour in connection to implementation of incentive programmes. However both observations might be equally true depending on the respondent's prior experiences. According to Wright managers who are risk-averse tend to be attracted to organizations which are characterised by less performance based compensation systems.

All our respondents except Sjöstrand recognise the retentive aspect of incentive programmes, which is also brought forward by Cox who's studies have shown that a late pay-out date have a retentive effect on employees. Having a delayed pay-out date also holds the benefit of providing the employee an indication of which level next year's bonus is going to be set. This can in turn serve as an extra motivation of staying with the firm in good times.

Image is also used as an argument for implementation incentive programmes, Qviberg, Bryngelsson, Ström, Rytter and Winlund state that firms with an attractive incentive programme are sending out a message. They are branding themselves stating that they are performance oriented and not afraid of sharing profits with employees. We have not found this aspect discussed in financial theory or management literature. However we would like to exemplify the image building incentive programme of Svenska Handelsbanken which is well documented in Swedish media and often referred to by our respondents.

Agency costs of managerial discretion are sometimes referred to as an important reason to implement incentive programmes. None of our respondents have stated that agency theory is an important factor when incentive programmes are implemented in state owned firms. Instead the board are solely in charge of mitigating value destroying actions made by managers, which is done through monitoring.

Theorists often put forward the mitigation of managerial discretion and agency costs when advocating the implementation of incentive programmes. However we received little to none support for this whilst conducting our empirical observations. Instead our respondents have focused their argumentations for incentives toward motivational, retentive, image and cultural aspects. This could however emanate from theoretical unawareness amongst our respondents.

In the current guidelines the CEO is excluded from all incentive programmes. This is in total opposition to all of theory presented in our theoretical framework. These theories do instead identify the CEO as the single most influent person in the firm, who should be the first to include in an incentive programme. This opinion was also confirmed by all our respondents.

### **5.3 Incentive design**

According to Jensen, given that shareholders take on the role of residual claimants with a limited liability, the shareholders satisfy all other claimants and accept all residual risk. In order to maximise their own wealth shareholders must also consider the wellbeing of other stakeholders. Turning management into shareholders ensures the value maximization of all stakeholders. All our respondents agreed with Jensen's thoughts regarding them as effective from an agency perspective. All respondents with the exception of Sjöstrand and Förander perceived incentive programmes as a good measure to attain this.

The ability for managers to sell shares or stock options in an open market causes the mitigation of agency costs to decrease. Our respondents therefore felt it necessary for managers who take personal stake through the purchase of shares to hold the shares over time in order for measure to be effective. Winlund brought attention to the fact that this in combination with having their human capital tied up within the corporation, results in an inefficient risk diversification that could become stressful.

Copeland et al stresses the importance of designing incentive programmes structured with a linear compensation. The benefit is that it offers a better mapping of the employee's performance, by distributing a constant percentage of the value created through the employee's actions. This can not become reality at present since the governmental guidelines regulates a cap of maximum two months salary bonus pay-out. However, the opinions on whether or not to uncap the incentive programmes differed widely among the respondents.

When discussing whether or not to make incentive programmes more long-term, multi-period oriented programmes including compensational banks such as Oktogonen came up. Vasakronan AB as well as Vasallen AB used to have bonus banks in connection to their incentive programmes prior to the new governmental guidelines.

When using Rappaport's theory as an analytical tool difficulties of employment on state owned firms are revealed:

(1) *a relatively large ownership position*; this is not a possibility since the state would not commit to a management buy out. Theoretically synthetic options could be created but would surely not be easily comprehended or transparent.

(2) *compensation tied to shareholder return performance*; this however can and is already applied. Most of the state owned firms that use incentive programmes tie a reasonable share to the ROE or equivalent.

(3) *threat of takeover by another organization*; not applicable due to owner situation

(4) *competitive labour markets for corporate executives*; concerning the competitive labour markets for the corporate executives our respondents express a quite congruent view of state owned and private firms competing for the most competent managerial labour. If a manager fails he can be replaced by an equally competent one.

Two out of the four are non applicable which disables incentive structuring using the Rappaport approach. Theory is difficult to fully align with the reality of state owned firms which is displayed when taking a closer look.

## **5.4 Measurements**

*The reason for implementing any incentive programme is to enhance and excel employee performance, building up loyalty, appreciation and goal congruence in collaboration with the owners. An effective measure is essential in order to make out whether or not these goals are reached. Our respondents as well as our theoretical framework have stated the importance of having an efficient measure to derive and award performances that are above average.*

Stewart as well as Rappaport regards that an effective and well-communicated measurement allows a firm to have a single focus for operations management, capital budgeting, planning, performance measurement, and incentive compensation. Both SVA and EVA are easily combined with the guidelines for state ownership. EVA wishes to link performance incentives more closely to increases in shareholder wealth. The state has earlier used the EVA measurement but at this point employ ROE as a standard performance measurement. A

substantial part of the bonus pay-outs are derived from this measure. EVA further aims to provide a single focus for all corporate activity which is in line with the wish for transparency communicated among our respondents.

Qviberg, Rytter and Bryngelsson acknowledge the same line of thought that was put forward by Stewart in the theoretical framework. Namely; that a culture of high performance that cultivates a competitive mindset is essential in order for a firm to derive excellence out of their employees. This will lead to managers both taking more initiatives acting in the interest of owners and themselves at the same time. EVA promotes a positive culture stimulating high performance, which is also in line with respondents and the states view of striving for excellence.

Whereas for instance Bryngelsson believes that it is beneficial to a firm to switch incentive programmes once in a while the SVA and EVA build on continuity and long-term commitment. A more long-term focus is communicated through bonus banks and multiple period based bonuses. Our respondents are in favour of incentives being set dependent on the performance over multi periods.

A closer look at theory shows that EVA and SVA are not about high bonuses but just and fair systems. The programmes can easily be structured in a way that disables extraordinary pay-outs and a compensation bank system can be included that will smoothen the bonus pay-out over a longer period of time. We furthermore believe that massive pay-outs can be easily avoided if structuring the programme correctly. This is perfectly aligned with the thought put forward by our respondents who state that an incentive should keep employees on their toes but not affect their sleep at night.

## **5.5 The role of the board**

The state seems to have a view on corporate governance issues that to a large extent is in line with the theoretical framework. Since the state has decided to exclude CEO from all incentive programmes and to limit the monetary aspects in existing incentive programmes, the disciplining role of the board has increasing.

According to agency theory independent board members are imperative for the board to remain effective. Although the respondents perceive that state owned boards have improved over the last years they believe that they are still less competent and independent than private peers. This is much due to appointment of nominees based on political achievements and opinions. Since these persons may lack adequate competence they can not function as the monitoring and independent board members that are required to mitigate agency costs of managerial discretion. The state's decision to no longer allow the CEO to be a member of the board of directors is fully in line with the recommendations of agency theory and an effective measure to increase independence. Since the CEO is not a member of the board he can not influence the appointment of board members, thus the danger of a board packed with CEO friends becomes much smaller.

Qviberg does concur with neither agency theory nor the other respondents. To him board independence is not a virtue since he does not assume monitoring to be part of a board's main responsibility. Instead Qviberg's arguments are in line with the stewardship theory. He thinks that an active board is excellent but the role is mainly to coach and advice the CEO and the management team.

Ogden presents four main tools available to the board in order to discipline management. These can be applied on state owned boards. The boards have a relatively strong power representing only one owner and therefore one interest. The lack of relevant competence is an important issue which affects the power of the board since they might rely too much on CEO information and expertise. The views expressed in our theoretical framework as well as the respondents' views on active board work do correspond. It is important for the state to maintain the small board sizes as of today as well as the board meeting frequency. This will enable more effective protection of the interests of the owners.

A popular topic in politics of today is the enforcement of quotas to include women and different ethnicities on board of directors. The risk is that this will affect state owned firms even more. The state owned firms are more intensely monitored and will have to adjust to new regulations at a higher pace than others. This can further compromise the quality and the competence in state owned firms making them fall even more behind private firms.

## ***5.6 Considering Macroeconomic effects***

Whether or not firms should filter macroeconomic fluctuations before rewarding managers is a complex issue. Oxelheim & Wihlborg suggest that the manager can not be in control of all external factors that affect the cash flow of the firm. In order not to avoid rewarding a manager that is under-performing but simply operating under beneficial circumstances. Whilst not punishing an over-achieving manager operating under harsh conditions.

Oxelheim & Wihlborg want to reveal the true value-creation. Our respondents identify this as a correct statement but can also perceive advantages in attacking the issue from a different angle. They suggest a view where image, retention and recruitment issues are taken into account. In addition to this a number of our respondents are sceptic as to which macroeconomic factors that should be taken into account and to which degree they should affect the incentive pay-outs.

## ***5.7 State vs. private owner's perspective***

In a regular private owned firm it is a virtue to align management and shareholder interest by giving the manager the motivation to choose strategies and make operational decisions in the quest of maximising shareholder wealth. Judging from our respondents this objective is not as vital, communicated and highly valued by the state. The state does want management to act in line with their wishes but by excluding the most important person, the CEO, the state has chosen a strategy in opposition to both our theoretical framework as well as our empirical study.

Cox stresses the importance of retaining key employees in times of downturn and recessions. A common way to do this is tying managers through long-term incentive programmes. This approach is not shared by the state owned firms where no incentive programme reaches



further than one year. Incentives running longer than one year and without caps are important cornerstones in both SVA and EVA. As mentioned no long-term incentives hinders the short-term focus among state owned firm's management. There therefore exists a risk that they perform just enough to get the bonus pay-out and refrain from realizing full potential until the coming year in order to achieve a new bonus pay out. This serves as a clear example of managerial discretion and agency cost.

## Chapter 6: The concluding thoughts

*After reading material on the subject and interviewing experts we have come to understand that politics complicate things. The political agenda is not always compatible with business theory. Representatives of state owned firms try not to regard their business as being partially ran by public opinions, while in fact they are. Political issues are however not the subject of our thesis and we have neither focused our research on this. We do dare to conclude that being state owned is not solely beneficial to a firm. In this chapter we summarize our concluding thoughts after performing the research and writing this thesis.*

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The state owned firms carry a great responsibility and are crucial both to the Swedish economy as well as to the 200,000 employees working for them. As of today only a few of the state owned firms have chosen to keep their incentive programmes. Since the owner through the guidelines have expressed a negative view on incentive programmes most company boards have found it better to totally abolish the incentive programmes rather than keeping sub-optimal ones. To us this progress seems risky, especially if the long-term ambition is for the state-owned firms to be value-creating but just as important to remain attractive as an employer. The state aim for long term value creation but do not employ all measures available. This creates a duality which makes it difficult to analyse the policies and guidelines of the Swedish state using our theoretical framework. The fact that the state holds a progressive position with the goal of changing certain relationships regarding equality and ethnic representation is also difficult to comment on. We find little support for these objectives in our theoretical framework, and can therefore only conclude that the success or failure of these policies have yet to be determined.

We believe that it is important to keep in mind that the politicians posing as owners of a state owned firms will never have the same interests as a true owner. Judging from the opinions of our respondents we congregate that the corporate world is to a large extent driven by aggregation of personal wealth and self-fulfilment. This makes true owners, in the role as residual claimants, care for the firm in an entirely different way. After all, it is more important for the government to be publicly appreciated and re-elected than to earn an extra billion for the state. This represents the contradiction that makes out the essence of this thesis and displays the difficulty in applying business theory on state owned firms.

The fact that the Swedish citizens own the firms creates a situation where the management can never become proper owners or shareholders in a state-owned firm. All through this study we have thought of how the most owner-like incentives can be created without actual ownership. We have become aware of the considerations that have to be taken to public opinion and politics. According to our personal view these considerations can not be allowed to cause implementation of sub-optimal incentive programmes. Such actions are taken in order not to displease anyone but the result threatens to be very expensive.

The current incentive programmes in the state owned firms are mostly about increasing the motivation among employees. The way they are structured is better compared to a provision rather than a sophisticated incentive programme. We can not perceive that they function as an efficient device for mitigation of agency costs. The share of variable compensation is too moderate in comparison to the fixed compensation to have any real effect.

There is a financial aspect in refraining from the use of incentive programmes. By maintaining low incentives the state-owned firms will inevitably have to increase, in order to offer a competitive compensation, the fixed salary. While bonus pay-outs are taken from earned money and realised profits, a high fixed compensation will remain unchanged also in years with negative performances. This compensational structure attracts a certain type of manager who is generally more risk-averse, less innovative and has a lower propensity to invest in for instance R&D. Not all state owned firms are commercial and would therefore not benefit from a competitive corporate culture. However, the firms concerned by our research are all active in a competitive environment which calls for a competitive focus.

Attracting and retaining managers and employees is a key success factor in a harsh corporate climate. This is applicable also to state owned firms which aim at being competitive as well as profitable. When wanting to attract high performers to a firm building an image that fits this kind of people is essential. Incentive programmes can be one way to communicate that the firm appreciates a good performance and is not afraid of rewarding high achievers fostering a competitive corporate culture.

The current governmental guidelines handicaps the incentive programmes in several ways. The exclusion of the CEO has certain consequences. The CEO is the single most influential person within a firm. This makes him unique and the person that is most important to monitor and to govern. The uniqueness of the CEO also set high demand on the recruitment process which should aim to attract the most competent person. The state has an invert relationship to incentive programmes judging from the usage of variable pay that is increasing in Sweden as well as worldwide. Given the branding, image and retentive aspects of the recruitment process the state risks to reduce the recruitment base. On the other hand bearing the branding aspect in mind the state policy and guidelines may seem more attractive to the more idealistic type of CEO wanted by Sjöstrand.

The fact that the state holds a restrictive attitude towards incentive programmes makes them differ from the views suggested in our theoretical and empirical framework thus leaving the board with a great responsibility. Our respondents together with our theoretical framework stress the different roles available for the board to take. An active board could and should have a large impact on the management of the firm through *service*, *strategy* and *monitoring*. Sjöstrand amongst other puts forward the continuous communication between the chairman and CEO as essential for the board to function in an effective way. Both our empirical and theoretical framework support board independency. Activity and independency set high demands on the board and we believe that it is largely dependent on individual performances. Incentive programmes make it possible to structure the processes and thereby protecting the firm from individuals' shortcomings.

We believe that most efficient structure is when an active board is complemented by a well structured and individualised incentive programme. However, this structure is not possible given the current guidelines and policies employed by the state, which in turn might lead to sub optimizations in the governing.

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## **Interviews**

Håkan Bryngelsson	CEO Vasakronan	20 <sup>th</sup> of April 2006
Sven-Erik Sjöstrand	Professor SSE	24 <sup>th</sup> of April 2006
Mats Ström	Vattenfall AB	25 <sup>th</sup> of April 2006
Marianne Förander	Industry Ministry	25 <sup>th</sup> of April 2006
Mats Qviberg	CEO Öresund AB	25 <sup>th</sup> of April 2006
Lennart Zadig	Management Consultant	26 <sup>th</sup> of April 2006
Leif Rytter	CFO Vasallen AB	15 <sup>th</sup> of May 2006
Gunilla Winlund	VP HR, V&S	16 <sup>th</sup> of May 2006