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Bottom Up

At Planar Systems, an inverted bonus plan rewards lower-level workers before their bosses. Its creator tells us how it works.

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Shareholders First: *Planar CEO Balaji Krishnamurthy*

BEAVERTON, Ore.—When the bonus gravy train arrives at **Planar Systems** Inc., the company's leader occupies the caboose.

Balaji Krishnamurthy, 49 years old, crafted an unusual inverted bonus plan soon after he took command of the company, a maker of flat-panel displays, in fall 1999. Planar (www.planar.com) must exceed tough operating-income goals that benefit shareholders before rank-and-file workers receive quarterly or annual bonuses. Middle managers don't get a dime until those junior employees pocket their full target. Executives stand in line behind managers. Dr. Krishnamurthy, the chairman, president and chief executive, becomes the ultimate shock absorber during downturns.

As business bosses everywhere struggle to restore their tarnished credibility, investors are paying closer attention to pay practices that truly hold management accountable. The inverted-bonus plan "puts incentives where they belong. It rewards from the ground up," says Cynthia Richson, director of corporate governance for the State of Wisconsin Investment Board, which owns about 8% of Planar's shares. "I hope that other companies will follow suit," Ms. Richson adds.

The plan is among several innovative compensation approaches embraced by Dr. Krishnamurthy, a former Tektronix Inc. executive and General Electric Co. researcher with a Ph.D. in computer science. "When I walked into Planar, I knew I wanted to make big changes," recalls the CEO, a swift speaker who talks with ardent conviction. He discussed the pay changes at Planar, a small company with about 500 workers, during a frank chat at its headquarters here. Excerpts follow:

THE WALL STREET JOURNAL: *One institutional investor said your inverted bonus scheme sounded like socialism. What's the philosophy behind this atypical plan?*

DR. KRISHNAMURTHY: It is the furthest thing from socialism. A very capitalist approach drives us.

People talk about corporate governance as it pertains to the external world. Particularly in light of the recent events in corporate America, it is very important. But corporate governance has another component, and that is internal corporate governance—bringing everybody, not just directors and officers, into alignment with shareholders in a manner where they see both the responsibility and the rewards.

Different people in the company have different levels of influence on the results of the company. The higher the degree of influence, the greater the stewardship responsibility you have for ensuring others have been taken care of. You depend on others to deliver shareholder value. You want to encourage and entice them.

So the bonus plan is one where we link everybody's variable compensation to the results. In addition, we place a stewardship responsibility on those with a higher capacity of influence to ensure that the payout for those with a lower capacity of influence takes place before they put their hands in the cookie jar.

Cookie-Jar Approach

WSJ: *How does the cookie-jar approach differ from traditional profit-sharing programs?*

DR. KRISHNAMURTHY: In a capitalistic environment, those who have a higher capacity of influence get paid more than those with a lower capacity of influence.

Getting paid first is a different matter. I don't think that in other companies somebody purposely designed the system so that those with a higher capacity of influence will get paid first. It is an incidental consequence.

Our system recognizes that the company's larger populace can only be measured on some corporate metric: operating profits. Higher-level managers have additional business metrics that they must meet.

The shareholder stands first. Rank-and-file employees next. Middle management after that. Executive management behind them. I, as the CEO, stand at the end of the line. People at higher levels get paid quite well. But they get paid only after they have discharged the stewardship responsibility they have.

We buy the top quartile of the labor market. But you have to pay them top quartile. They are entitled to that pay only if the company performs in a top-quartile manner. Base pay is at the median of the market, but the variable compensation allows the total package to be an attractive top-quartile package. We pay bonuses quarterly and annually.

I, as a CEO, have a responsibility to make sure the company performs in that top-quartile manner and ensure that rank-and-file employees get that top-quartile pay.

WSJ: *When did you cook up this bonus idea?*

DR. KRISHNAMURTHY: In my very first year as CEO. Everybody on the executive team immediately signed up for that fundamental philosophy of stewardship responsibility. Everybody said, "Yes, it makes a lot of sense."

For each quarter, we take care of the shareholder base first through adequate profits.

WSJ: *So Planar must meet an operating-profit target before it hands out money to anyone else?*

DR. KRISHNAMURTHY: Absolutely.

WSJ: *And your roughly 350 rank-and-file employees must ...*

DR. KRISHNAMURTHY: Get 100% of their target—5% of their base salary—before middle management gets 100% of their target.

WSJ: *Does the target vary for each level of management?*

DR. KRISHNAMURTHY: Yes.

WSJ: *Must management meet additional performance measures beyond operating profits?*

DR. KRISHNAMURTHY: That's right. So it is quite possible that there is operating profit available to pay them, but they do not achieve the specific business metrics that we have put in place. They do not get paid.

WSJ: *Why did you create this bonus plan? After all, studies show that cash bonuses rarely change employee behavior over time.*

DR. KRISHNAMURTHY: I wanted every manager to recognize that unless their department completely performs according to the company plan, their personal rewards were at stake. Every month when we have our financial forecasting meeting, it is very clear whether you are going to get good bonuses.

In most situations, when we are short, we are short by so much that the 10 people sitting in that financial review are the ones who are not going to get their bonuses. The first question they ask themselves is: "What are we going to do to make the numbers in the next few quarters?"

WSJ: *Doesn't that promote manipulative tactics to manage your earnings?*

DR. KRISHNAMURTHY: There are very legal ways to manage earnings, and that's the only way we practice.

What you really want is people to be focused on the delivery of the promises we made to the Street. They have a very clear understanding at the end of that financial review as to what we need to do to make that happen.

Another thing that happens is the executive leaves that room and bumps into John, who has not really been pulling his weight, and asks: "Why are you putting up with this?"

Another guy goes into another room where there is a meeting of marketing people and he is really pumped up into exciting them [about] the program that needs to be put in place for the next few quarters.

This is a direct result of two things: A recognition of what does it take to make the numbers so that people get paid. And two, the stewardship responsibility we have so that everybody gets paid. Because you know you don't get paid until everybody gets paid.

Selfless and Selfish

WSJ: *Making sure everybody else gets paid so you also get a bonus sounds both selfless and selfish. I wonder how people below your top management team reacted.*

DR. KRISHNAMURTHY: Did middle managers think the plan was crazy? Yes, because it was so different. There have been times when the rank and file have gotten partial payment and middle management has not. There has been no backlash.

Middle management almost feels empowered by it. Middle management looks at this as a balancing force to our very tough environment. We want the best people, but we take care of them.

Let's say we've made it our target to report $20 million operating income, for example. Our internal plan would show something like $24 million in prebonus operating income with $4 million intended for bonuses. So if we only make $20 million or less, each dollar would be reinvested in the company for the benefit of shareholders.

But beyond the $20 million threshold for shareholders to get their due, employee groups are sequentially paid bonuses depending on the extent of available funds. For a target bonus to be paid to every employee, including me at the end of the line, we'd have to reach $24 million in prebonus operating income.

It takes a big pothole before the shareholder feels it. Anybody in the front of the line has a shock absorber. The further back you are, the less of the shock absorber that is left. Imagine how bumpy my ride is.

WSJ: *How does that feel?*

DR. KRISHNAMURTHY: It is exactly why I wanted it. I am confident that I have the capacity to make a difference.

WSJ: *During fiscal 2001, the plan's first year, your bonus was twice your $350,000 salary. But you got no bonus for fiscal 2002 ended last Sept. 27. What happened to everyone else both years?*

DR. KRISHNAMURTHY: In every quarter of fiscal 2001, every employee group at least hit their target. Also for the year as a whole.

Once 100% of target is reached and all have gotten their take, all people are eligible for "leverage" amounts.

WSJ: *And that maximum is 10% of salary for rank-and-file workers?*

DR. KRISHNAMURTHY: Yes. It's 5% when this group hits its target, and another 5% if the company exceeds all of its targets.

In fiscal 2002, the rank and file in one quarter got a portion of their target amount. Remember, if they get a portion, the next guy gets nothing.

WSJ: *What went wrong?*

DR. KRISHNAMURTHY: The economy just caught up with us. We did much better than most companies. But it was not up to the level that we had promised the board of directors.

WSJ: *How well did Planar do during fiscal 2003's first quarter, which ended last Dec. 27?*

DR. KRISHNAMURTHY: We delivered on our performance for shareholders. And everybody got paid bonuses across the board. By the time it reaches me, everybody has gotten 100%.

All through fiscal 2002, we continued to make money. We generated huge amounts of cash. But our budget was quite aggressive. In fiscal 2003, we set a budget that is more appropriate for the economy we live in.

WSJ: *More modest targets than 2002?*

DR. KRISHNAMURTHY: Yes.

WSJ: *Other companies' bonus plans typically favor the CEO over the lowest-paid worker. Did that "me-first" mentality have anything to do with recent corporate scandals?*

DR. KRISHNAMURTHY: We have taken a few bad situations and extrapolated that to all CEOs. CEOs get paid the most. What is important is to make sure they don't get paid unless they deliver. Boards have not held their feet to the fire.

You are better off creating a structure where if you do well, you get paid very well. And if you don't do well, you pay the consequence.

Our fiscal 2002 performance was very good compared to the market. But we did not rewrite the rules and say everybody should get paid bonuses.

WSJ: *Was there pressure to do that?*

DR. KRISHNAMURTHY: None whatsoever.

Taking Stock

WSJ: *Let's now look at your executive stock-ownership requirements. What's the rationale?*

DR. KRISHNAMURTHY: I want everybody at the executive table to have skin in the game: direct stock ownership of between two and five times their base pay. We give them five years to attain that.

WSJ: *Have you met your personal ownership goal of five times your $400,000 salary?*

DR. KRISHNAMURTHY: I have not attained that level. I am on the trajectory.

WSJ: *Are you thinking about extending this requirement to middle managers?*

DR. KRISHNAMURTHY: I am not. You walk a fine line between putting people in harm's way and incentivizing them.

WSJ: *Your thought process seems similar to your inverted bonus plan. Executives have ultimate accountability and should get rewarded only if everybody else is adequately taken care of. But you also want executives to have skin in the game as a means to promote that stewardship.*

DR. KRISHNAMURTHY: Our annual incentive plan is a short-term plan. Make this year's performance adequately good. But you always want a counterbalance in terms of the long-term plan.

WSJ: *As seen in another unusual pay practice here called leveraged stock options. Did that idea also grow out of your initial compensation review?*

DR. KRISHNAMURTHY: Yes. When I joined the company, a regular stock-option plan was the only long-term plan. The leveraged stock-option plan had to do with the following observation: When you buy a share at a certain price and the share price falls, that's a bigger pain than if you have options that have risen and then fall.

The leveraged stock-option plan is designed to take advantage of that emotional pain. I said, "Let's cause our executives to periodically go out there and buy stock." A share-price drop will hurt you emotionally and cause you to do something about it.

WSJ: *Yeah, you'll get a job where you don't have to deal with such silly requirements.*

DR. KRISHNAMURTHY: There have been a number of cases where I have had conversations with candidates for executive positions and they were uncomfortable with the topic.

WSJ: *With leveraged stock options?*

DR. KRISHNAMURTHY: Specifically, how you must go out and buy stock. Take money out of your wallet every year, put it on the table and buy stock.

Every year, executives are required to buy stock in the open market to the tune of at least 10% of their base pay. No discounts. Irrespective of trying to meet ownership guidelines.

WSJ: *Do you still have to buy shares even if you have met your stock-ownership requirements?*

DR. KRISHNAMURTHY: You still do.

It forces you to constantly be a market participant and shareholder. The incentive part is this: For every share you buy, the company gives you nine options. That is the leverage. If you really think that you can make things happen, you can really get rewarded.

The options are not automatically vested. [They vest] only if the stock appreciates adequately. Adequately is defined as faster than the cost of capital to the company over a three-year period. This provides a long-term incentive for executives to continue to create shareholder value.

It is separate from the annual option plan. As a result, you see insiders go out and buy.

Test of Character

WSJ: *How often have leveraged options cost you candidates?*

DR. KRISHNAMURTHY: A few times. Almost every candidate raises their eyebrows. It exposes the psyche of the individual. We want the person who has the confidence, the conviction, the commitment to be at the table. If you don't, go work somewhere else.

WSJ: *Under the leveraged stock-option plan, do those options eventually vest?*

DR. KRISHNAMURTHY: If, after three years, the stock has appreciated faster than the company's cost of capital, the leveraged stock options fully vest.

If the stock hasn't risen at the required pace, the options vest after five years, but the annual options the executive would otherwise have been granted that year will be reduced by that amount. This simplifies accounting for any nonvested options, while making sure no reward is given if the stock price doesn't appreciate adequately.

WSJ: *If you were remixing the palette for executive pay elsewhere, what would you change? Why don't you take zero cash, for instance?*

DR. KRISHNAMURTHY: I am not sure that zero cash pay for the CEO really benefits you. You just lose a huge candidate pool. I would have been one of those you would have lost.

WSJ: *What do you think it would take to persuade other companies to follow Planar's unusual compensation model?*

DR. KRISHNAMURTHY: I am not thinking about how I am going to get other people to adopt it. It will be a while before they follow us.

On the other hand, internally, we have a lot of excitement and commitment to these plans. They created a culture of fiscal responsibility across the entire organization. You go down the organization and it is felt by every individual. ▦