

Board Governance Series

VOLUME V 2005

A KEY EDUCATIONAL RESOURCE FOR TODAY'S BOARDS OF DIRECTORS



- 6 Section 404: Lessons Learned and a Look Ahead
- 10 Structuring “Unassailable” Executive Compensation Programs
- 12 Guidelines for Board Evaluations
- 14 Eight Essential Steps to Building Ethical Corporate Cultures
- 18 A Legal Victory for Boards in Troubled Times
- 20 New Areas of Focus for Compensation Committees

CORPORATE
BOARD MEMBER
MAGAZINE

NASDAQ[®]

LRN

PRICewaterhouseCOOPERS LLP

SIBSON CONSULTING

WEIL, GOTSHAL & MANGES LLP

Structuring “Unassailable” Executive Compensation Programs

Blair Jones, senior vice president and practice leader, Leadership Performance & Rewards for Sibson Consulting, reviews how corporate boards can structure compensation programs that support their strategy execution.



Blair Jones
Senior Vice President and
Practice Leader, Leadership
Performance & Rewards
Sibson Consulting

When it comes to executive compensation plans, so many companies these days have taken the approach of “following the leader,” thinking it will keep them safely under the radar. Unfortunately, such thinking can lead to a lost opportunity. You might stay out of harm’s way, but you also could miss the chance to use executive compensation to move your business forward.

As we speak with boards and management teams about what they can do to make their programs as unassailable as possible, we focus on three tactics. First, create compensation pay levels that are business-based and informed by the business strategy. Second, when designing the compensation program, take into account the organization’s unique business characteristics, talent characteristics, and performance and rewards strategy. Third, monitor the pay/performance relationship closely and make necessary adjustments over time. Let me give more detail about each tactic.

With pay levels, the typical practice has been to examine a peer group and see what that market is paying. Common wisdom says if you’re attracting talent from or losing talent to a certain market, make sure you’re on par with the pay levels within that market. However, we believe that transitioning to where a company needs to be today demands following a set of “new rules.” In line with these rules, we’re encouraging companies to examine how certain roles differ in their ability to impact the business strategy. Then, use that information to decide how best to apply the market data. For example, in the retail industry, Wal-Mart’s business strategy is based on being the low-cost provider. Given that strategy, operationally-focused roles like supply-

chain management are most important in that business situation. In contrast, Saks Fifth Avenue has a strong merchandising focus, so merchandising roles have a high value to Saks. In examining the market data, Wal-Mart might want to direct higher pay to operations-based roles whereas Saks might want to pay more for merchandise-based roles. The other, less strategic roles could then be managed at a lower pay point. This approach enables a company to take a limited universe of pay dollars and use them to greater effect, so that the roles most important to achieving the business strategy are the ones in which the most dollars are being invested.

Tactic two has to do with plan design. It involves creating designs that are unique to a given business. Again, the typical practice is to look toward the marketplace for direction. Perhaps the market seems to be shifting away from options and toward restricted stock. Restricted stock may work for some companies, but clearly it is not the answer for every company. Rather than focus on the market, it’s better for companies to look at their unique business strategies and business characteristics. For instance, is a company going through a growth stage or is it a mature company? Each stage would have different pay design implications. Is the company going to create value through dividends, or is it going to create value through stock-price growth? Talent characteristics must also be considered. For example, what type of people is the company trying to bring into the organization, and how stable is that population? Is the hiring profile focused on entrepreneurial individuals or people who will be loyal to the company and build a career over time? Do the business units operate fairly autonomously? If yes, it may be wise to motivate those business units

differently across the corporation. A company also needs to consider its performance and rewards strategy. Is it a priority to build ownership over time? Does the company need to drive change right away? The answers are going to be different for every company; therefore, the compensation design should be different too. We don't let competitors drive our business strategy so why should we let them drive our compensation strategy? By looking at their own unique factors, companies can assemble designs that truly complement their unique purposes.

The third tactic in making a pay program unassailable is to examine the pay/performance relationship and to constantly monitor and adjust it. Again, traditionally companies have looked to the market for reassurance

higher than individual's pay should be. To address these kinds of issues, companies are examining the pay/performance relationship in different ways. For instance, they look at how much value is being shared with executives through compensation dollars relative to what is being shared with shareholders. Companies also are looking at how much of their earnings and cash flow are being paid out in cash-based programs—in other words, how much productivity are they getting from their pay? The idea is not to search for a magic number, but rather to explore a variety of different angles in the pay/performance relationship. It's important to understand how those dollars are being shared among employees to ensure they are being used to the greatest effect. Depending on what a

“We don't let competitors drive our business strategy so why should we let them drive our compensation strategy?”

that their pay is “OK.” More recently, companies have asked, “How does our pay align with our performance?” Every March, the *Wall Street Journal*, analyzes how companies pay their CEOs and how the pay relates to company performance. The time has come to be more creative in how that pay/performance relationship is assessed. Alignment has served companies well over the past decade, but the market has taken a major uptick in recent years. If companies continue to align pay with peer groups, what happens if those peers overpay? There's no way to adjust for that overpayment. In another example, say someone is performing at the top of the market, it's hard to know how much

company finds, it can go back and influence the pay levels and pay designs.

Of course, you can never ensure that your pay program is going to be entirely unassailable. But it's helpful to think about what would happen if your company's CEO was featured in the national, regional, or local list comparing CEO pay to performance. What story could you tell about how the CEO's compensation package is constructed and how that pay design supports strategy execution? That's the true test of unassailability.