

Strategic work valuation

COMPENSATING THE RIGHT EXECUTIVES THE RIGHT WAY

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Given shareholder scrutiny and tight budgets, compensation committees face a true challenge: making limited dollars stretch further, particularly for those positions that would be hardest to replace and are most critical to strategy execution. Doing the right thing in compensating executives is trickier than just following what the market pays; compensation committees must consider what's right for the organization.

In the past, executive pay has most frequently been determined through reference to market practices. Using a market reference, a company essentially allows its competitors to determine what and how to pay its executives.

QUICK LOOK

- ⇒ Doing the right thing in compensating executives is trickier than just following what the market pays; one must consider what's right for the company.
- ⇒ Executive pay should reflect the company's unique business strategy, and the reality that some management positions are more vital to achieving that strategy than others.
- ⇒ Strategic work valuation balances factors relating to both the external market and the internal business strategy to help companies better align their talent and business strategies and focus the compensation spend on positions that have the greatest impact on business results.

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Applying SWV can result in **maximized efficiency** of the compensation spend.

A market-based approach also fails to capture the differences among different organizations and management teams.

Executive pay should reflect the company's unique business strategy and the reality that, within an organization, some management positions are more vital to achieving that strategy than others. To support this view, this article presents a new business-focused approach to determining executive pay called "strategic work valuation" (SWV).

SWV is a simple concept that balances factors relating to both the external market and the internal business strategy to help companies better align their talent and business strategies and focus the compensation spend on positions that have the greatest impact on business results.

SWV can apply to all elements of executive pay, whether salary, annual or long-term incentives.

At the executive level, SWV may be best used in the incentive portion of the pay package, where there is greater leverage than in the salary component.

For executive incentives, SWV offers significant flexibility and a logical, transparent and equitable process for setting incentive levels, establishing plan leverage and selecting incentive measures. Applying SWV can result in maximized efficiency of the compensation spend and enable incentive plan designs that really do align executives' interests with the business strategy.

How It Works

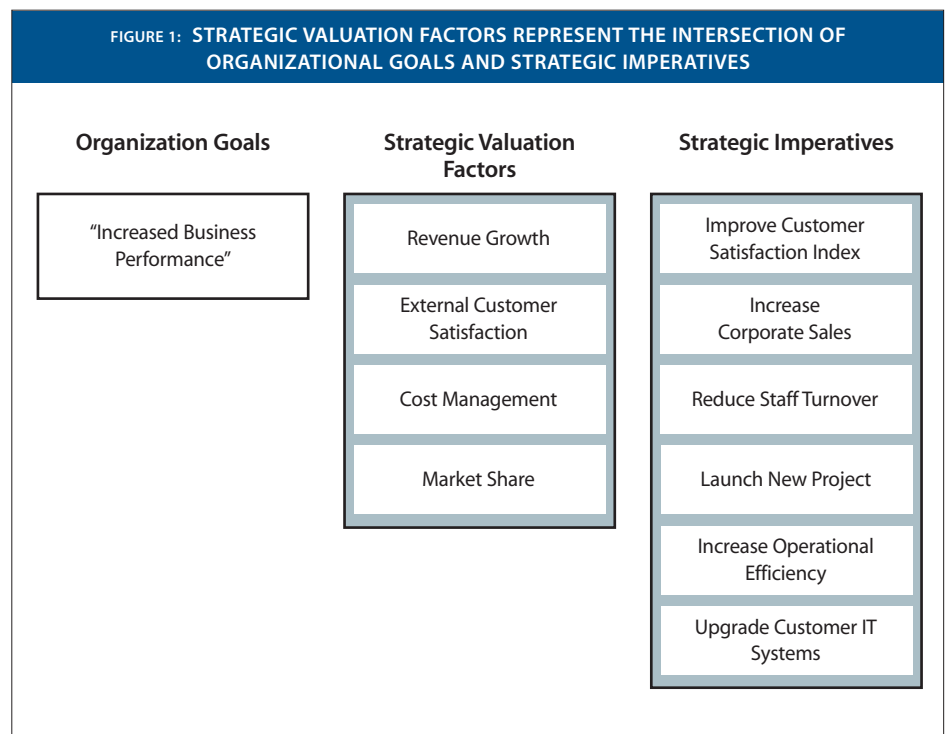
SWV optimizes the link between positions and the value they create for the organization. The central premise is to value positions based on their impact on driving the company's key strategic imperatives. The theory behind this approach is as simple and logical as it sounds. The aim is to determine where

value is created in an organization, and then use this information to prioritize human capital investments.

One might argue that all positions at the executive level are vital to the business. While all positions are integral, some have greater prominence. For example, in retail, those businesses following the low-cost provider model, such as Wal-Mart, might weigh toward paying supply chain and other operational managers more than merchandisers. The opposite might be true in a high-end fashion business. In both businesses, the supply chain managers and merchandisers are important, but in the different environments one group has a greater effect on achieving results and is more vital to success than the other.

Strategic valuation factors form the heart of SWV. As shown in Figure 1, these factors represent the enduring areas of value creation for an organization given its operating and business model. Unlike traditional internal valuation factors,

FIGURE 1: STRATEGIC VALUATION FACTORS REPRESENT THE INTERSECTION OF ORGANIZATIONAL GOALS AND STRATEGIC IMPERATIVES



strategic valuation factors come directly from the company's business strategy. They are neither short-term, annual strategic objectives, nor the ultimate business outcome, but the "levers" within the organization that drive achievement of the strategic imperatives and lead to ultimate business success.

Typically, three to five strategic valuation factors arise from a robust process of analysis and direct input from the compensation committee of the board of directors and senior management. Input may involve structured interviews with board members and the executive team about the business strategy and operations, plus group discussions to define and agree on the organization's unique strategic valuation factors. The give and take between the compensation committee and management is not adversarial, but rather a partnership focused on teasing out the factors that truly create strategic value. Generally, the compensation committee verifies the strategic valuation factors and reviews and provides input to the position assessments.

To ensure fairness, all voices need to weigh a position's business impact. Conversations to develop the factors typically are based around the following key questions:

- What are the enterprise's longer-term financial and strategic objectives?
- What will create and/or sustain competitive advantage?
- To what extent do answers to these questions vary across business units (requiring different strategic valuation factors for each unit)?

In most cases, analyst reports on the market, the company's competitive position and key business priorities provide additional input to the factors. A "value chain" analysis, which illustrates the financial, strategic, customer and operational drivers of total return to shareholders (TRS), also can be useful for defining the leverage points to business results. In fact, this type of analysis was a key input for Blue Cross Blue Shield of Louisiana in developing its factors.

Once defined, the strategic valuation factors are used to determine the strategic value of each position in the organization. Positions should be compared across a management tier rather than vertically, as the more senior positions within any function have the greater ability to impact the strategic business drivers. For example, when Standard Register, a service-based information solutions provider, adopted SWV, senior management and the board identified three types of executive positions: those with high strategic impact, medium strategic impact and lower strategic impact. These valuations were then used to drive pay and other people-investment decisions.

Once each position has an identified, internal strategic value, the external market value is determined through the typical pay benchmarking process. The strategic value is then used to set pay positioning within the competitive market range. In this way, SWV marries both internal and external evaluation. Typically, positions with high strategic impact are paid a premium, and medium strategic impact positions are paid around, while those with lower impact are paid at or below the market.

The actual positioning for each category of positions is based on the overall pay strategy and is affected by the organization's desire to maintain, increase or reduce the total compensation spend. Often, SWV results in varied competitive positioning for individual positions, but a competitive overall compensation spend because the process is about reallocating compensation dollars to focus them in the most

SWV marries both internal and external evaluation.

strategic way. In effect, while pay opportunities for the most strategically important positions are increased, these costs can be partially or fully counterbalanced by a reduction in opportunities for lower-impact positions.

While this approach may seem tough to communicate, the reality is that business strategies do differentiate the value of different positions. However, it is critical to note that the process assigns values to positions, not individuals. Target pay opportunities are developed as ranges rather than single points, so room remains to reward a high-performing individual in a lower-impact position — just within a restricted range.

It also is important to remember that market data is not one data point, but a range of pay levels in the marketplace, where higher levels typically reflect larger roles. By lowering target pay ranges for lower-impact positions, organizations

are actually better calibrating these positions against the correct part of the competitive market range. Over time, companies may find that they want to use these lower-impact jobs as developmental opportunities or, ultimately, as outsourcing candidates.

Valuing a position at a certain level does not determine that position's ultimate destiny for all time. As the company changes and clarifies or readjusts its strategy, the strategic valuation factors and the value of executive positions may well change. In fact, over time the strategic assignments should be re-examined and confirmed or revised given strategic shifts.

Executive Incentive Level, Leverage Design and Plan-Measure Selection

SWV can be used to set target incentive levels for executives based on the position's ability to affect the company's business strategy. The process can be applied to all positions below the CEO. SWV is not appropriate for setting compensation for the CEO, as this position has no comparative positions in the same tier and should always be compensated based on the company's overall performance.

Valuing a position at a certain level does not determine that position's ultimate destiny for all time.

Becton Dickinson, a world leader in the medical equipment industry, recently initiated SWV throughout the organization. Having struggled with inconsistent compensation practices on a worldwide basis, Becton Dickinson adopted SWV as part of a multiyear strategy to improve the return on its global compensation investment. At the executive level, the company uses SWV factors to develop target annual incentive ranges for all management levels below the top 10 (whose incentives are individually set by the board). The resulting incentive levels

balance global consistency and market alignment, and ensure that opportunities are clearly linked to the impact different positions have on the business, wherever those positions are based.

SWV factors also can be used to set differing incentive ranges or leverage for different positions, based on their strategic impact. This application allocates the most strategically important positions higher maximum-incentive opportunities, or a wider incentive-opportunity range, than those in positions with lower strategic impact. Thus, the organization can reward the high performers in key positions with significantly greater incentives.

For example, Figure 2 on page 27 shows pay levels for positions within a management tier that are measured against the SWV factors on a three-point grading scale. Positions in tier 1 have the lowest impact on business results, tier 2 positions have medium impact and tier 3 positions have high impact. In this example, the higher-impact positions (2 and 3) have greater incentive leverage than the tier 1 positions. Those positions with the highest impact on business results would carry higher performance expectations in addition to the higher pay opportunities. In many organizations, the logical next step in the SWV process is to use it as a talent management tool to align the best talent in the organization to the mission-critical jobs.

The principle also can be applied to any leveraged short- or long-term incentive-plan design. For example, one private engineering firm's innovative executive annual-incentive plan allows cash profit-sharing bonuses to be invested in company stock, with employee investors receiving a "free" stock option for every two shares purchase. Applying SWV to such a design could give the high strategic-value positions even higher leverage by awarding more options per share purchased.

As these examples illustrate, SWV makes explicit what many organizations already spend a great deal of time doing when they "adjust" executive incentive targets or leverage based on the relative importance of positions. For example,

one Midwest utility has consistently positioned incentive opportunities for its top 15 executive positions against the 75th percentile of its utility industry peers. By ranking its own top 15 positions in order of importance to organizational goals, rather than matching each position to the market on a traditional job-content basis, the company offers higher incentive opportunities to the most vital positions. For example, a position that was sixth in importance within this utility company is paid comparably to the sixth-highest paid

The strategic valuation factors provide indicators about **appropriate incentive measures.**

position at competitor organizations, regardless of the competitor position. Based on the same logic, SWV can provide a defensible approach for compensating positions differently and allow clarity around why incentive opportunities for different positions should differ to reflect their relative business impact.

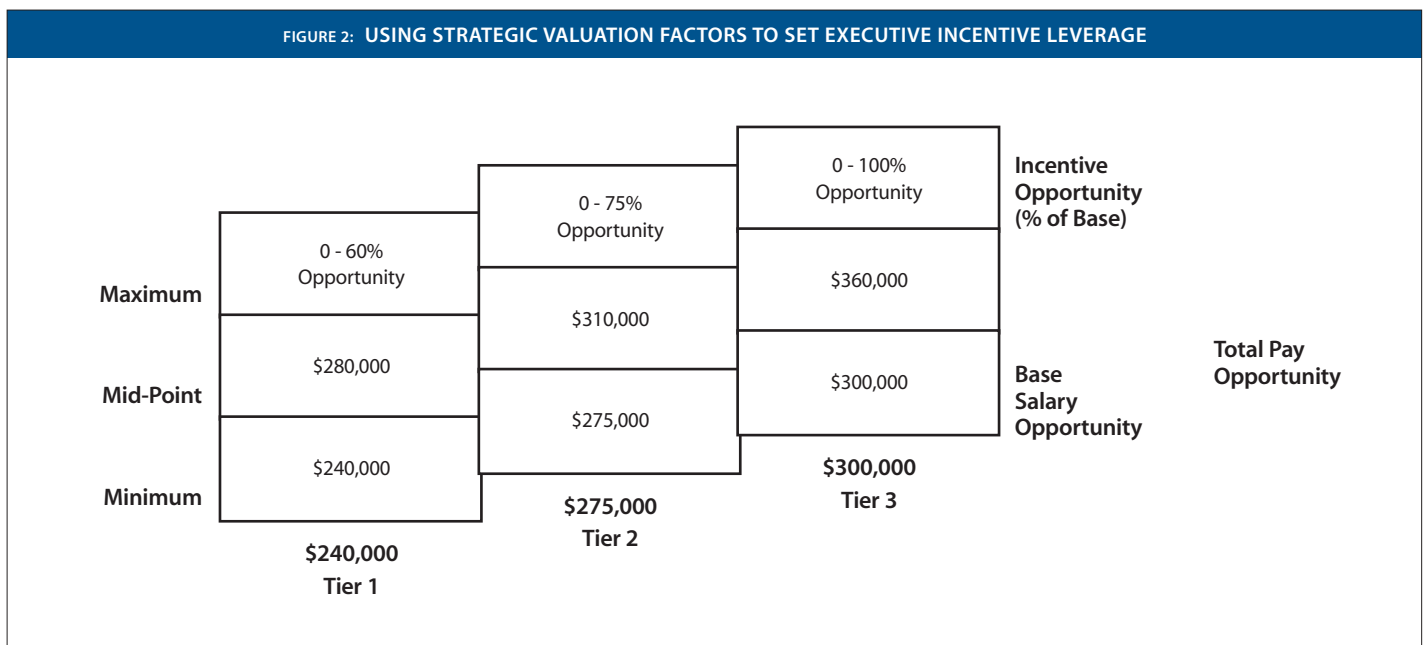
A third application of SWV to executive incentive design is in supporting the development of incentive-plan measures. By drilling down and defining measurable factors against which to assess the strategic impact of positions, the SWV process also can be used effectively to develop incentive-plan measures, whether for annual or long-term executive incentive plans.

The prevalence of business-based performance metrics in executive incentive plans has increased dramatically as compensation committees seek to defend the equity of their plans. An increasing number of *Fortune* 500 and a majority

of FTSE 100 executive short-term incentive plans now include explicit performance measures, as do more than 30 percent of *Fortune* 50 and 90 percent of FTSE 100 executive long-term incentive plans. The most common measures are earnings per share (EPS) and profit for annual incentive plans, and EPS or total shareholder return (TSR) for long-term incentives. SWV helps support this process and ensure that a plan's performance measures are the best measures to support an organization's specific agenda. The strategic valuation factors provide indicators about appropriate incentive measures, enabling a company to establish a robust set of measures for incentive plans centered on the business' own strategic and operational objectives.

Figure 3 on page 28 illustrates how an organization could use the SWV Factors to develop executive incentive-plan measures. For example, if revenue growth is a strategic valuation factor, a complementary incentive-plan measure

FIGURE 2: USING STRATEGIC VALUATION FACTORS TO SET EXECUTIVE INCENTIVE LEVERAGE




might be an annual or longer-term increase in revenue versus a competitor peer group.

Final Thoughts

SWV offers compensation committees a simple, logical approach to setting executive compensation levels and developing incentive-plan design measures that are anchored in the strategic drivers of the business. This robust approach can support the organization in attracting and retaining talent while ensuring that the compensation

spend is efficiently and strategically allocated.

SWV also offers wider applications beyond compensation and can be used for value-based decision-making for all people-based investment decisions, from organizing talent to ensure that the key people are in the mission-critical positions to determining what work can be outsourced. (See Figure 4.) As an additional benefit, SWV can be a means to generate conversations between managers and staff about where value is created in the

organization. These discussions create a greater understanding of the business and its strategy throughout the organization. 

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FIGURE 3: USING STRATEGIC VALUATION FACTORS TO DEVELOP EXECUTIVE INCENTIVE-PLAN MEASURES

Strategic Valuation Factor	Example Incentive-Plan Performance Metrics
Revenue Growth	One-, three- or five-year revenue change Revenue change versus an index or peer group
External Customer Satisfaction	Customer satisfaction index Customer retention (e.g., membership or "churn" rates)
Cost Management	Operational expense Net income
Market Share	Market share by revenue Market share by volume

FIGURE 4: STRATEGIC WORK VALUATION APPLICATIONS

