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A New Framework for Executive Compensation

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Editor's note: Seymour Burchman is managing director at Semler Brossy Consulting Group, LLC. This post is based on his Semler Brossy memorandum. Related research from the Program on Corporate Governance includes Paying for Long-Term Performance by Lucian Bebchuk and Jesse Fried (discussed on the Forum here).

The nature of change in business today differs from the past in both magnitude and pace: Technology is disrupting fundamental business models, forcing transformation across whole industries. According to a 2019 Accenture study, 71 percent of 10,000 companies in 18 industry sectors are "either in the throes of or on the brink of significant disruption." Similarly, McKinsey concluded a major study of automotive, electronics, aerospace, and defense industries, saying, "The industrial sectors will see more disruption within the next five years than in the past 20 years combined."

At the same time, societal forces and new business priorities are undercutting shareholder primacy while strengthening other stakeholder interests. Strategic stability has fallen from its pedestal in favor of strategic agility.

The responses to this disruption, however, have not been matched in long-term incentive design. Conventional plans reward executives for winning over three years. Because companies now are vying to reshape their business over much longer periods, executives are essentially tied to a structure that supports only incremental change versus radical transformation. This disconnect means a clash is inevitable.

It should come as no surprise that the directors we speak with on board compensation committees have become increasingly concerned. Could conventional three-year plans inadvertently encourage executives to compromise long-term performance? Are the plans' structures too inflexible to allow for quick strategic pivots? How do stakeholder interests fit into plans that have long focused solely on financial results? We get these questions particularly from tech firms, which we believe are precursors for other industries.

The solution to the disconnect is not obvious, because the search for new plan designs poses an apparent riddle: How do you set goals for long-term transformation, short-term strategic agility, and the building of stakeholder ecosystems all at the same time? Doesn't that require irreconcilable tradeoffs?

Let the Mission Guide You

As it turns out, no. Not if you design your incentive plans around mission, rather than strategy, attaching targets and incentive payouts to those goals in a disciplined way. Your company's mission offers consistent, yet flexible, guidance for long-term transformation, agile course corrections, and the building, operation, and constant reshaping of stakeholder-rich ecosystems.

For effective guidance, a mission needs to answer specific questions that can be translated into long-term, measurable goals:

- **Who or what** are we benefiting?
- What **stakeholder outcomes** are required to create that benefit?
- How can we **continuously improve** those outcomes — and **outperform** competitors?

Take Southwest Airlines as a hypothetical example. Its mission is "dedication to the highest quality of customer service delivered with a sense of warmth, friendliness, individual pride, and company spirit." The vision is "to become the world's most loved, most flown, and most profitable airline."

Southwest's statements contain the essentials for creating outcome- and stakeholder-based incentive measures that can be improved each year and calibrated to outperform competitors. It makes clear that customers and employees are among the key stakeholders to benefit along with shareholders. Company directors could tie performance to measurable goals, such as:

- Customer measures, such as Net Promoter Score (loyalty), customer satisfaction score, and/or churn rate
- Employee engagement, attitudes, satisfaction, or turnover rates
- Number of passengers or passenger miles flown
- Brand strength relative to industry, over time
- Returns relative to competitors, over time
- Profitability relative to competitors, over time

These measures are enduring and not linked to the particulars of the strategy chosen for achieving them. In other words, they don't put a straitjacket on agile strategic changes during long-term transformation. Although executives will have to make short-term, either/or tradeoffs that favor the interests of one stakeholder, these goals encourage choices that provide a balance for *long-term sustainable performance.* Research by Alex Edmans at the London Business School and Rob Markey at Bain & Company reinforces the importance of establishing this balance. Their studies show that companies with high employee satisfaction and high Net Promoter Scores materially outperform their peers.

It's up to boards to narrow the focus to two to three mission-based measures that will serve as the basis for a long-term incentive plan, and then to set goals based on those measures. The goals need to be both specific enough to guide actions and measurable enough to show performance improvement. To complement the long-term goals, directors should set annual incentive objectives as intermediate milestones to gauge progress toward long-term outcomes. Using the Southwest example, this could be the percentage of on-time flights as compared to all flights.

The Evolution to a New Standard in Long-Term Incentive Pay

Standard incentive design today	**Standard design for tomorrow**	**Rationale**
Strategy-driven	Mission/purpose-driven	More enduring and flexible
Shareholder-centric	Stakeholder-centric	Broader focus to reflect mission
Strategic milestone-focused	Stakeholder outcome-focused	Consistent, longer-term focus
Financial goals primarily	Financial and nonfinancial goals	Better aligned with mission/stakeholder outcomes
Overlapping independent cycles	End-to-end cycles, using the same outcome measures for each cycle	Longer-term focus, avoiding contradictory annual goals
Budgeted performance	Goals that improve: (1) at a set amount over prior cycle and (2) relative to peer performance	More enduring over time while avoiding tie to strategic plans

Particularly important, this new approach avoids today's problematic time-horizon conflicts. This change could seem like a detail, but it is in fact central to addressing a root cause of short-termism and promoting long-term performance. When boards annually approve a new set of three-year goals, they of course leave in place the still-running three-year goals from the prior two years. That creates three sets of goals, which may well conflict. Instead of these overlapping goal cycles, we suggest moving to end-to-end cycles where the goals remain constant throughout a given cycle but in succeeding cycles the measures remain the same, while the goals become progressively more difficult. This new approach holds executives accountable instead for stable long-term, outcome-based goals.

This approach also avoids problematic board-management negotiations over which goals will anchor the incentive plan. Instead of getting paid for hitting budgeted numbers set in a negotiating dance with the board, executives would earn incentive payouts based on showing continuous improvement over the prior year, and on outcompeting peers.

When it comes to payouts attached to the incentive plans, directors could offer equity based on the achievement of the chosen, precious-few mission-based outcomes. To assuage the concerns of shareholders, who are always eager to know that the fortunes of executives are tied to their stock-market-driven fortunes, pay plans could require executives to hold a significant amount of stock for the long term, even beyond retirement.

With this approach to redesigning long-term incentives, the board has a bookend approach that resolves the disconnects we have today. The specifics of the mission on the front end tie nicely to the specifics of incentive pay on the other. Tying long-term incentives to the mission also allows a new, natural balance between annual and long-term incentives in influencing executive behavior. Short-term achievements can be rewarded in annual bonus plans and long-term outcomes in long-term plans.

In the era of radical strategic transformation, executives and boards may have no choice but to consider how to make long-term incentives work better. If companies are to respond to disruptions, if they are to remain agile, if they are to rally stakeholders to work together to deliver outperformance in today's data-dependent business ecosystems, they risk getting behind the curve if they stick with standard incentive design today, which so prominently features three-year goal-setting processes based on financial measures. The company's mission or purpose, elaborated by its vision, can become "true north," not just as a driver of an extension of the past, but a springboard to the future.