A Cautionary Tale for New Compensation Committee Members

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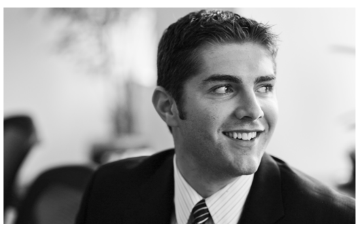

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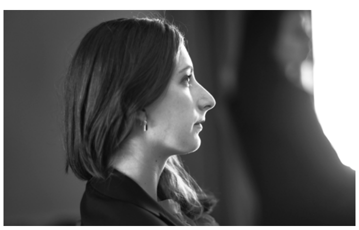

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New directors bring fresh perspectives that contribute to a healthy discussion of all aspects of a business, including compensation, and often challenge the status quo (a notion which can be both good and bad). However, where compensation is concerned, directors would be well advised to look before they leap. While management teams and boards pay considerable attention to the alignment of pay with performance and strategy, there is often less explicit consideration given to a company's culture — its core values and beliefs, and the expectations of its people. Culture represents "how we do things around here." Culture embodies leadership style within an organization and enables work getting done in a way that supports goal achievement. If the compensation program sends signals that are counter to the culture, the program can cause organizational dissonance, generate unintended outcomes, and lead to serious consequences.

We believe that ignoring the cultural aspects of pay can have serious consequences, particularly if culture plays a prominent role in the business. When an organization's culture is very strong, it tends to influence and be influenced by all aspects of the business, including the pay programs. Because directors are not involved in the day-to-day operation of the business and have limited firsthand experience in "how things get done," they can sometimes have trouble grasping the company's culture. And they may jump to conclusions based on trends from their own companies or peer organizations — conclusions that may not be applicable in a different context.

If the perspectives of a new director are to be positively rather than negatively disruptive, they should be rooted in the organization's business model, strategy, fundamental economics, and culture. Though the focus here is on culture, all of those elements should inform decision-making. However, that doesn't mean preserving the status quo. Any element that is adversely affecting company performance should be changed, and the compensation program can often be used to drive or reinforce such changes.

Culture Shock

Consider what can happen when a board fails to take culture into account in a company's pay program. An organization we'll call "Company A" — a vertically integrated operation encompassing design, manufacturing, distribution, retail stores, and customer service — focused on providing a superb experience for its customers and building and maintaining a strong brand image. Senior leadership was largely grown from within, and the company worked seamlessly as a team, emphasizing collaboration and shared accountability for all aspects of the customer experience.

Company A's culture was encapsulated in its five stated values:

- "Delighting the customer is our highest priority."
- "We succeed or fail as a team."
- "We strive to be the leading innovator in our space."
- "Our brand represents our future."
- "We seek career-minded people, not free agents."

Initially, the company's compensation program was well-aligned with its business model, strategy, economics and culture, and included the following elements:

- **Annual incentive plan:** based on company-wide metrics including net operating profit before bonus, with a modifier addressing a combination of customer satisfaction and the percent of revenues from new products. There were no individual performance adjustments.
- **Long-term incentive:** comprised of 50 percent options and 50 percent performance-vested restricted stock units, with vesting based on market share. Target awards were modified for individual performance and potential.
- **Advancement philosophy:** positions filled internally, unless a new skill was needed. Succession planning and development were ongoing with a significant commitment of resources. The company's rapid growth had provided ample opportunity for advancement. Pay increased meaningfully with advancement.

Major changes in the program came when the incumbent CEO had to resign due to a sudden illness. Because no internal candidates were ready to assume the role of chief executive, the board hired a new CEO from outside the company. At the same time, a new member of the board was appointed chair of the compensation committee. Both the CEO and the new board member understood the advantages of the company's culture, but after discussions with other board members they concluded that there were certain aspects of the culture that were hindering performance (e.g., departments might better contribute with higher accountability). Both men had experience in other companies with formulaic and highly differentiated compensation programs. They had seen how those types of compensation programs could be strong drivers of performance, with considerable variation by department and individual and with strong line-of-sight. They thought an approach that assigned more accountability and hard metrics might lead to stronger growth and profitability. Given their views, the Compensation Committee worked with management to implement a new approach to pay design, which included:

- Performance measures addressing both corporate (50%) and department (50%) performance
- Significant individual adjustments in all elements of the compensation program
- Highly-leveraged commission programs for sales team members based on individual sales closed
- A highly formulaic annual incentive plan focused exclusively on two financial metrics — revenue growth and profits — because customer satisfaction and new product metrics were deemed to be too "soft"
- A long-term incentive plan comprised of 50% options and 50% performance-vested restricted stock units, with vesting based on both free cash flow and market share

These changes fundamentally altered two key things that had made the company successful:

1) the collaboration that had supported a seamless end-to-end total customer experience and 2) the customer-centric focus. Departments began to concentrate on their own performance and were unable to work together to provide the same level of customer service and experience as previously. Sales people focused on sales and coordinated less with manufacturing. The sales teams oversold the product, resulting in order backlogs. Manufacturing managed production costs and cut corners to catch up and to meet their new department-specific performance metrics. Quality and customer satisfaction suffered along with the brand image. Ultimately, this led to sales dropping, although margins did improve at least initially. Discontent with the changes caused turnover to increase significantly above historic norms.

Thinking About Culture and Pay

How can Compensation Committees better design compensation with culture in mind? The table below, though not intended as a comprehensive framework, depicts the dimensions of culture and pay that we have found in our compensation work to be the most influential and how they interacted at Company A.

Defining Aspects of Culture	Illustrative Levers for Pay Design	How Changes Made at Company A Conflicted with Existing Culture
Importance of team versus individual	• Relative emphasis given to team goals (e.g., corporate, division, function) vs. individual goals • Degree of variance in actual pay delivered to individuals	Shifted from exclusive company focus to departmental/ individual differentiation
Degree to which risk-taking is encouraged/ discouraged	• Degree of leverage and upside in incentive plans • Mix and design of long-term incentive vehicles (e.g., options vs. full value shares) • Inclusion of deferral and clawback features • Extent to which judgment and discretion are used vs. purely formulaic approaches	
Tolerance for and encouragement of change	• Inclusion of non-financial goals (e.g., especially related to change/ innovation) • Periodic review of pay designs to reflect evolving strategies and business models • Use of flexible approaches to reward innovative ideas and their execution (e.g., use of special awards and programs) • Sufficient judgment to not unduly punish "failures" deemed acceptable	Removed new product-related metric
Hiring for long-term careers versus swinging door	• Career-oriented pay designs vs. short-term or transactional pay schemes • Appropriate opportunities for reasonably spaced promotional pay (along with supporting systems) • Appropriately structured and sized pay for those on developmental assignments	
Long-term vision versus short-term needs	• Relative weight given to long-term pay vs. annual pay • Adequate length of long-term performance cycles • Ongoing programs versus mega awards focused around milestones • Stock ownership requirements • Inclusion of strategic measures in annual incentive plan	Removed customer satisfaction metric

The case of Company A provides a *cautionary* tale for companies with well-intentioned directors who may not appreciate that the changes they desire may be more suited to cultures they had known in the past. For Company A, the unintended consequences of the changes in compensation design ultimately outweighed the benefits. While the compensation actions were perfectly reasonable both from a market perspective and from what the new CEO and compensation committee chair saw as areas for improvement, they were a poor match for the situation. In making decisions regarding pay design, directors need to understand and take into account the company's culture. And although it is appropriate for new Committee members to challenge the status quo, they should beware of importing past solutions into new situations where they may be less directly applicable.

In a future blog, we intend to explore two other cases. In the first, a company's culture was inhibiting needed reforms, and the compensation program was used to help drive cultural change. In the second, a new compensation committee chair advocated for changes in the compensation program, as was the case in Company A, but he changed his mind when he fully understood the negative consequences that might follow.

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