One of the specific questions one might ask is what could be in such an errant company’s strategic objectives? In how performance is measured and communicated? In how executives get paid? In the shaping of the culture itself? What dysfunction could foster the kind of pre-meditated behavior that has now led to the tarnishing of VW’s great global brands, dismissal of key executives and according to recent estimates, $45 billion of potential liability in the US alone?

Executive compensation is a particular and obvious target of blame when corporate scandals like this erupt. In an “I told you so” sort of way, people will remark, “You get what you pay for.” But decades of experience in working with companies on the design and administration of pay programs suggests pay is not the obvious culprit. The reality of such situations is more nuanced.

For starters, pay has been under the microscope for years, so a lack of pay scrutiny does not make sense as the main driver of indiscretions. Boards of companies in the US have been required to address shareholders directly on the topic of pay programs and their potential for driving excessive risk taking since 2010. That was a result of widespread belief that the financial crisis was at least in part a product of corporate compensation programs. One of the proof points of this belief was the case of AIG Financial Products, a unit of the large insurer. AIG Financial employed a small fraction of AIG’s workforce but it used the parent company’s balance sheet to create, sell and trade financial derivatives. That balance sheet imploded during the financial crisis due to the cratering of the derivatives market. The US government put $182 billion into AIG to stabilize it.

So today we have a mandate requiring boards to report in the annual proxy statement whether the company’s incentive programs “are reasonably likely to have a material adverse effect on the company.” Not surprisingly, it’s impossible to find a proxy statement today that says, “We believe our company’s pay programs are reasonably likely to create risks that could be material and adverse to the corporation.” Nonetheless, the new regulatory regime has pressed companies to take stock of their programs and obliged boards to review them to state the opposite. While the reviews have prompted some tweaks, in our experience, few companies have found enough problems with their pay designs to compel them to make a real overhaul.

We think the reason for this is that the hard-coded design and terms of pay programs rarely have inherent risk. Instead, it is the soft stuff that makes for excessive risk taking. It’s important to make the distinction between the “hardware” of pay programs and the “software” that goes into them.

To illustrate, let’s look at two companies with similar annual bonus plans whose outcomes were going to be highly dependent on each management team hitting an annual profit target. The “hardware” in these incentive plans was similar. Both had the same minimum “cut in” of profit required before the plan paid, the same slope of the payout schedule once minimum profit was achieved, and the same overall payout opportunity for each executive. But the “soft” processes that went into the plans was quite different, and that’s what made all the difference in executive behavior.

For Company “A,” setting the profit target at the beginning of the year followed months of planning and dialogue among top management to balance a top-down view with a bottom-up perspective. The top-down view reflected long-term strategic

NOTES FROM THE FIELD
Risk May Not Be Inherent in Pay Designs
Written by Roger Brossy

One would be hard-pressed not to be slack-jawed over the revelation of fraud at Volkswagen in late 2015. The audacious scale of the perpetration—11 million cars, over 8 years, in 36 countries—was hard to fathom. Bad acting on both this and a lesser scale drives observers of corporate governance to reflexively ask, “What’s going on at the top?”
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goals, the expectations of investors, and growth prospects for the industry. The bottom-up process required business leaders within the company to propose what they would “sign up for” in terms of sales, costs, investments for the future, and ultimately, the coming year’s profit. The process of putting these two perspectives together was not without stress and a few bruises. A realistic take on human nature would easily explain that the CEO and her CFO wanted a little more profit than predictably cautious, self-protective business-unit heads collectively put in for. But an engaged process with “eyes wide open” led to a negotiated goal to which everyone ultimately agreed.

In Company B, the hard-charging CEO set the numbers. A master of the facts, she entered each discussion with her business-unit heads armed with data and analysis she hadn’t shared with them beforehand—a dynamic which put them at a disadvantage in the discussion. Business-unit heads no longer had the tough, full-disclosure discussions with their boss, and so she often didn’t have realistic forecasts of the future. The business-unit heads had learned that what had seemed a sensible dictum of “no surprises” had warped over the years into an unwritten rule of “never be the bearer of bad news.” Harsh career consequences had been dispensed to those who had brought bad news forward before. Unsurprisingly, the goals for Company B were pushed down from the top and hardly “owned” by the business leaders.

Thus, we have two companies with very similar incentive plans for top management, but very different ways of getting to the numbers that would govern plan payouts. The behavior and tone that went into setting the goal itself and how the players behaved as the year went on could not have been more different. That’s the software. And while no wrongdoing occurred, when Company B faltered in the second half of the year—because it failed to perceive changes in increased capacity at its competitors that in turn caused a downward shift in pricing—it should not have been too much of a surprise. Managers in Company B had their heads down and were trying to stay out of trouble with their boss. The market intelligence that could have been gained in a more open environment was simply unavailable.

Which brings us back to Volkswagen. Hardware or software? We would have to be insiders to have insight into what really occurred at VW. But consider this: Prior to the revelation of wrongdoing, Volkswagen publically disclosed in multiple places its “Group Strategy 2018.” This strategy declared an aspiration for the company to be a “global economic and environmental leader among automobile manufacturers.” The strategy was broken down into four goals—a model of balance by almost anyone’s standards. One was a measure of customer satisfaction, which was reported on annually since 2007. A second was employee satisfaction, which was similarly measured and reported. A third was to achieve a long-term return on sales of “at least eight percent so as to ensure that the Group’s solid financial position and ability to act are guaranteed even in difficult market periods.” Finally the fourth was to generate unit sales of more than ten million vehicles a year and to “capture an above-average share of growth in the major growth markets.”

A skeptic would seize on this last goal and suspect it was the real driver of executive pay outcomes—the customer and employee satisfaction objectives likely being window dressing. VW’s pay disclosure suggests this is not the case. While the German disclosure regimen for pay is different from that in the US, the substantial long-term incentive (LTI) plan at VW is based on performance...
against each of the four objectives of the strategy. To an experienced eye, this suggests that more of executive pay at VW was subject to customer satisfaction (measured at the dealer level, and to end users in terms of new cars and service levels) and to employee satisfaction than would be typical in US companies. Yes, the annual bonus plan appears to have been tied to meeting short-term profit goals, and the long-term incentive would be zeroed out if the company failed to hit a threshold level of profit of 1.5% of sales (well below its goal of “at least 8%). But investors would surely want to know threshold levels of profit were being achieved before executives received performance-based pay.

So from the required disclosures, whatever happened at VW does not appear to be driven by the hardware of their executive pay programs. Courts, commissions, and investigative reporters will hopefully give insight over time into what was up with the software. At this stage, the Volkswagen story illustrates the nuanced role of executive pay in driving behavior. Pay programs may play supporting roles when bad behavior shows up, but it is more likely the soft stuff of culture is the culprit.

Boards would be well advised not to rely solely on the review of incentive plan hardware when looking for inherent risk in their company’s pay programs. Instead, they should consider how the soft factors—such as the so-called “tone at the top”—might mix with pay design to create an otherwise imperceptible yet toxic environment where risks are either excessively taken, or in other cases, not even perceived.

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