

Linking Strategy and Executive Pay

Boards must consider aligning management's business and personal goals

BY BONNIE FLATT AND LES DAKENS
Pineridge Consulting Inc.

THE RECENT ECONOMIC CRISIS MAY PROVE to have a silver lining – if organizations pay attention to the lessons it has taught. Consider, for example, the recent public outrage over executive compensation. While the furor has diminished, it hasn't disappeared. Looking ahead, a proactive way for boards to manage executive compensation is to more closely link compensation to company strategy.

Let's start with a few premises:

- A. The current pay and performance system is getting more complex – and it isn't working.** Adding more metrics to compensation procedures is supposed to make them work better, but it really only adds more complexity and better chances to “game” the system. As well, these metrics tend to be tied to lagging measures of performance rather than future strategy, which encourages short-term thinking.
- B. A majority of strategies fail because of organizations' inability to convert their strategies into actionable, executable plans.** Some companies do a great job of developing strategy, but fail to communicate it clearly or set actionable metrics against it. When compensation is not linked to execution of strategy, there is a fundamental disconnect between what executives are asked to do and what they are rewarded for doing.
- C. Companies fail to understand the relationship between the personal values of individuals who will be executing the strategy and the strategy itself.** As a result, some employees will either reject the strategy or won't engage.

Companies like Southwest Airlines, Apple and Zappos are examples of successful companies that have built a culture around specific values and purpose, hired people whose values align with that culture, and developed strategies that brought together individual and company values.

- D. Good strategy development requires in-depth understanding of the business.** The majority of board members must have an understanding of the industry and the true drivers of financial performance and results. This is especially critical when the board looks at the linkage of senior-level pay and performance.

Let's examine these ideas in more detail.

Build the Strategy First

Most organizations build their strategies based on external market factors, and don't consider the relationship between the strategy and the personal values of the individuals who will be *executing* the strategy. As a result, even the best plans may fail because people are not giving it all of their effort.

A different approach being applied in many organizations today, and taught in leading MBA schools, looks at a “new leadership model” as a way to better align values and culture with strategy. The core concept is to build strategy by taking into account a senior team's aspirations, along with external influences such as product life cycle, technology advances, and market demographics. (See the book *Tribal Leadership: Leveraging Natural Groups to Build a Thriving Organization*, by Dave Logan, John King & Halee Fischer-Wright).

The first step is to start with the “why”; what is our purpose, why are we here? Google's purpose is to



provide information 24/7. Southwest Airlines' purpose is to provide customers with a fun, friendly experience. Employees who join these companies do so because they believe in the cause and what the company stands for. The "what" takes into account the competencies that let you achieve, attain and accomplish your "why."

After you ask the "why" and the "what," ask yourself the "which." Which products, services, partners and assets do we need or want to bring our competencies and purpose to life? All of these questions should be asked and answered by the team responsible for executing the strategy. As mentioned previously, when strategy is aligned to the team's aspirations, there is greater commitment, engagement and passion for getting it done.

In this approach, leaders continually ask their teams the following questions:

- What's working well?
- What's not working well?
- What do we need to do to fix these problems?
- What else?

This ongoing re-evaluation of strategy keeps the team focused and engaged on working together to solve specific problems. Board members ask similar questions to pinpoint areas where the strategy may not be working or may require modification.

These holistic leaders look deliberately to align people's intrinsic values with work assignments that will create economic value for the organization. The strategy is developed in collaborative fashion within the senior team, and includes specific, actionable and clear metrics, both for the long-term and the short, to which the team commits.

Link Compensation to the Strategy

Traditionally, compensation programs provide three components: base salary, annual bonus and some form of longer-term, performance-linked compensation. The annual bonus plan is usually based on financial results achieved within a yearly business plan. It may also include individual performance goals that have been linked to specific, near-term strategic goals.

Longer-term performance rewards have typically been equity-based. Historically, stock options were

favoured, but now restricted share units (RSUs) have become common. Generally, RSUs are granted without performance conditions and vest in a specified period of time (generally three years, for tax reasons). On vesting, the executive receives a payout equal to the number of units vested, multiplied by the share price at the date of payout. In cases where performance conditions have been attached to the equity grant, they have most often been based on financial metrics or total shareholder-return results – which, for the most part, are lagging indicators of performance. It is rare to see performance conditions linked to strategic objectives.

So how should boards move forward as it relates to pay, performance and strategy? We suggest boards consider the following:

1. Keep the compensation program simple, clear and focused.

Compensation programs have become complex for numerous reasons, including tax effectiveness, regulations, and the perceived need to find more perfect metrics. The only real result of this increasing complexity has been to add more work for directors and shareholders in understanding how executive compensation impacts organizational risk, and the additional reporting required to explain the programs. It is questionable whether executives and the broader management group can see any link between their personal accomplishments and organizational success based on current compensation programs.

2. Use performance metrics that are wide-ranging, relevant and hard to "game."

As the strategy is developed and action steps established, the team responsible for executing the strategy should be asking the following questions:

- How will we know when we are successful?



- How will we know we are doing the right things?
- How will we know we are executing the right strategies?

These questions will lead to measureable outcomes that can be linked to both short-term and long-term compensation. Consider the following examples:

- Assume your strategy is to grow your business in Asia by a certain percentage over the next five years. The chosen metrics could be a specific number of viable leads in Asia, global growth targets and completed acquisitions. In order to link pay with the longer-term business strategy, you might decide to include a specific number of viable leads as a metric under the annual bonus plan, with the other metrics being tucked into the longer-term incentive plan.
- Assume a product-innovation cycle is part of your strategy; your purpose is elegant design and short-term execution. A metric to consider in your annual bonus plan could be the number of design ideas accepted, while the number of product launches and adoptions are included as metrics in the long-term incentive plan.
- If a company is considering a large IT expenditure such as SAP implementation, SAP milestones can be included in a longer-term incentive plan design.
- What about a company that's consolidating its operations? Important strategic considerations could include the speed and cost of consolidation, level of staff engagement, retention of customers and suppliers, and

community impact. Specific metrics around each of these outcomes could be factored into annual and longer-term incentive plans.

3. Use compensation as a mechanism for building collaboration across groups.

Successful companies encourage and build collaboration, rather than competition, between groups. As the authors note in *Tribal Leadership*, as organizations develop stable cultures, they attract people who respond to the values of the culture and thus tend to be more engaged in their work: "Setting and implementing a successful competitive strategy becomes easy as people's aspirations, knowledge of the market and creativity are unlocked and shared." Compensation strategy and design can support this movement by rewarding collaboration and knowledge-sharing.

Essentially, people want to do work they find meaningful. They want to be successful in their efforts, and to work within a successful organization. Devising a specific strategy, along with individual clarity about what the organization expects of its people, is key to that mutual success. Once that part is done right, boards can focus on compensation plans that will link back to and support the strategic imperative.

Bonnie Flatt can be reached at (647) 205-7879 or flatt@pineridgeconsulting.ca.

Les Dakens can be reached at (416) 529-4149 or dakens@pineridgeconsulting.ca. See also www.pineridgeconsulting.ca.

This article originally appeared in the Director Journal, a publication of the Institute of Corporate Directors (ICD). Permission has been granted by the ICD to use this article for non-commercial purposes including research, educational materials and online resources. Other uses, such as selling or licensing copies, are prohibited.