

February 16, 2010

Mr. Robert E. Feldman  
Executive Secretary  
550 17<sup>th</sup> Street, NW  
Washington, DC 20429

ATTN: Comments, FDIC

Dear Mr. Feldman:

WorldatWork respectfully submits these comments in response to the Federal Deposit Insurance Corporation's Advance notice of proposed rulemaking (ANPR), Incorporating Employee Compensation Criteria into the Risk Assessment System [RIN 3064-AD56, Federal Register Vol. 75, Number 11, 01/19/2010].

### **Background on WorldatWork**

WorldatWork ([www.worldatwork.org](http://www.worldatwork.org)) is a not-for-profit global human resources association focused on compensation, benefits, work-life and integrated total rewards to attract, motivate and retain a talented workforce. Founded in 1955 and formerly known as the American Compensation Association, WorldatWork provides a network of nearly 30,000 members in more than 100 countries with [training](#), [certification](#), [research](#), [conferences](#) and [community](#). It has offices in Scottsdale, Arizona, and Washington, D.C.

WorldatWork members are human resources practitioners who design and administer programs — including compensation plans — to attract, motivate and retain employees. Our members believe there is a powerful exchange relationship between employer and employee, as demonstrated through the WorldatWork [total rewards model](#). Total rewards involve the deliberate integration of five key elements that effectively attract, motivate and retain the talent required to achieve desired organizational results. The five key elements are: compensation, benefits, work-life, career development and recognition.

The model recognizes that total rewards operate in the context of overall business strategy, organizational culture and HR strategy as well as a complex external environment that influences the organization. Within this context, an organization leverages the five elements to offer and align a value proposition that creates value for both the organization and the employee. An effective total rewards strategy results in satisfied, engaged and productive employees, who in turn deliver desired performance and results.

Last November, WorldatWork commented on the Federal Reserve (“Reserve”) *Proposed Guidance on Sound Incentive Compensation Policies*. We have attached the letter and cited

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Mr. Robert E. Feldman  
February 16, 2010  
Page 2 of 2

resources to assist you in your process of determining whether or not to change the FDIC's risk-based deposit insurance assessment system, based on certain employee compensation schemes. WorldatWork hopes you find the resources helpful and informative as you consider the implications of changing your assessment system. The resources we have included are:

- The WorldatWork total rewards model.
- The WorldatWork Executive Rewards Questionary, a dictionary of questions for organizations to consider in designing or modifying their executive compensation programs.
- "How Companies Should Balance Growth & Financial Returns in Executive Plans" (June 2007 article from WorldatWork's monthly magazine, *workspan*, parts 1 and 2).
- A May 2009 survey that WorldatWork conducted with Loyola University, the Hay Group and the University of Sydney, *Rewards Alignment Survey: Alignment of Business Strategies, Organization Structures and Reward Programs*.
- "A New Day for Executive Compensation" (January 2007 article from *workspan*).

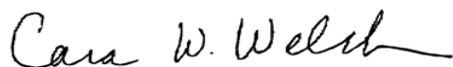
Although WorldatWork raised some concerns about certain aspects of the Reserve's proposed guidance, WorldatWork respectfully believes that the Reserve's process of reviewing comments — and any changes made to Reserve guidance as a result of the comments — should be allowed to run their course before further federal action on compensation schemes is considered.

WorldatWork notes that two of the three members on FDIC's board voted against the decision to issue the ANPR, cautioning that a more prudent course would be to let Congress and the Reserve proceed in its current efforts. WorldatWork agrees with the two dissenting board members and asks that the FDIC carefully consider the concerns laid out by them.

WorldatWork also notes that the Securities and Exchange Commission has implemented disclosure rules in proxy and information statements to increase transparency related to risk, compensation and corporate governance. These efforts may already be working to resolve identified issues, but more time is needed to be able to determine how successful they have been in improving corporate governance.

In conclusion, WorldatWork respectfully asks the FDIC to consider the enclosed materials and to pause before making changes to its risk-based assessment system. WorldatWork appreciates this opportunity to comment on the ANPR and is ready to provide any assistance or information needed to facilitate the FDIC's process. Please do not hesitate to call on us to provide resources, unbiased expertise on compensation plans, or any other type of assistance on compensation-related issues.

Sincerely,



Cara Welch  
Director  
Public Policy

# WorldatWork Total Rewards Model

Strategies to Attract, Motivate and Retain Employees



Second  
Edition



worldatwork  
executive rewards  
questionary

optimize executive compensation design



worldatwork  
executive rewards  
**questionary**  
optimize executive compensation design

From the leading non-profit, non-partisan association for compensation professionals, WorldatWork, comes a dictionary of questions that every organization should consider in designing or modifying their executive compensation structure — the *Executive Rewards Questionary*.

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*“Compensation planners have another tool for identifying executive compensation issues, courtesy of WorldatWork, an association of HR professionals focused on attracting, motivating and retaining employees. (The WorldatWork Executive Rewards Questionary) appears to be a simple, elegant device.”*

— Business and Legal Reports (BLR)

## About WorldatWork®

WorldatWork ([www.worldatwork.org](http://www.worldatwork.org)) is an international association of human resource professionals and business leaders focused on attracting, motivating and retaining employees. Founded in 1955, WorldatWork provides practitioners with knowledge leadership to effectively design and implement strategies and practices in total rewards – compensation, benefits, work-life, performance and recognition, development and career opportunities. WorldatWork supports its 30,000 members and customers in 75 countries with thought leadership, education, publications, research and certification

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# Table of Contents

Acknowledgements	IV
Introduction	V
Internal Environment	1
Stakeholders	6
External Environment	10
Disclosure & Transparency	15
Applying the Questionary in the Real World	25

# Acknowledgements

This list of key considerations in the development of executive compensation design was produced as a service to the compensation profession and companies everywhere by the members of the 2006-07 WorldatWork Executive Rewards Advisory Board.

The association extends a special thanks to the following individuals of the Board for their service to the profession and their efforts in building the professional body of knowledge.

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# Introduction

*“questionary. ques • tion • ary: n / a collection of questions...”*  
— *Webster’s Third New International Dictionary (Unabridged)*

## **What Is the *WorldatWork Executive Rewards Questionary*?**

More than 50 years ago, a small group of individuals from different companies in the Midwest formed a professional association around the topic of their shared work — designing and implementing systems to compensate employees and executives. That handful of individuals (who founded what would later become *WorldatWork*) could not have possibly imagined that within 50 years the topic of executive pay would be garnering almost daily headlines in the mainstream media.

But indeed today, the practitioners who are responsible for designing compensation plans are working under a microscope as they never have before. They must navigate an intricate system of diverse global business criteria while weighing internal and external competitiveness, accounting for investor and media reaction, and complying with a multitude of regulatory disclosure and transparency requirements.

This questionnaire — or list of key questions to consider in the design and implementation of executive pay systems — was created for them. It has been specifically formulated by practitioners for practitioners.

The *WorldatWork Executive Rewards Questionary* is the one and only comprehensive list of questions that should be reviewed and carefully considered when either creating or modifying an executive pay plan.

## **Why This Is Different**

In recent years, a number of organizations have produced “executive compensation principles” or “best practices in executive pay” reports and recommendations. This document takes a simpler approach. Instead of a list of “thou shalt not...”

statements or value judgments about one particular design practice over another, this document simply helps the compensation practitioner and his/her company think through all of the possibilities that might arise from the compensation element or plan he/she is considering.

But the true utility of this questionnaire will not be limited to practitioners. Indeed, corporate boards of directors (and specifically, compensation committee members), consultants, investors, regulators and members of the media will benefit by using this set of questions as a reference document.

To serve this mission, we have made this tool available free online to anyone who is interested at [www.worldatwork.org/execcomptool](http://www.worldatwork.org/execcomptool).

## **The Questionary in a Nutshell**

The questions in the *WorldatWork Executive Rewards Questionary* cover more than 225 issues that are critical for consideration while planning or modifying a company's executive compensation plan. It includes issues that might arise in aligning compensation with business strategy, regulatory issues, socioeconomic factors, disclosure and transparency rules, communication plans, labor and market pay trends, and even community concerns.

The first section of the questionnaire clarifies how strategic drivers are measured, if they are consistent across divisions and, if not, how this will affect compensation plan design. Next, short- and long-term objectives are addressed. Consideration is given to identifying the major milestones associated with these tactical and strategic objectives, as well as the major challenges to achieving the objectives and how expected performance relates to the current business outlook.

Developing a compensation philosophy depends, in large part, on specific company objectives, market orientation and target pay position. The questionnaire provides a template for considering performance leverage and perspective, and assessing how the compensation philosophy aligns with corporate strategy, culture and resources.

Another important element in plan design is a review of the measurement systems that provide the performance metrics needed to operationalize and administer the program. This includes effective auditing and financial accounting, reporting factors, and identification of key stakeholders or influencers who need to be part of the program development process.

Sound compensation plan development always requires the internal involvement of professionals from legal, finance, accounting, investor relations and tax. The questionnaire thoroughly covers the financial constraints (authorized share

capital, current burn rate, overhang, dilution, self-funding, internal hurdle rate of return and cash-flow requirements) that may affect program design.

The questionnaire walks the user through important shareholder approval (if it applies) and compensation committee/board of director review processes. The tool guides users in developing backup materials and other effective tools and processes to support committee members in their decision making.

Finally, in addition to all of the business and regulatory issues, the credibility and effective administration of an executive compensation plan is supported in the questionnaire by presenting questions related to external stakeholders and disclosure and transparency. These questions support the notion that time spent to fully think through and develop an effective communication program can be as critical to plan success as the plan itself.



# Internal Environment

The internal environment includes factors that are unique to each company and essential to consider when developing compensation plans that are effective in supporting the business strategy.

## Business Strategy

### Strategic Drivers

- A. What is your company's mission/core values?
- B. What is your corporate strategy?
- C. Where are you in the business life cycle (startup/high growth/mature/decline or renewal)?
- D. What are your competitive advantages and vulnerabilities?
- E. What are your key business objectives and strategic drivers?
  - i. How are they measured?
  - ii. Are the strategic drivers consistent across divisions?
  - iii. If not, how does this affect plan design?

### Short- and Long-Term Goals

- A. What are the results that need to be achieved in the short and long term?
- B. How do these short-term objectives (tactical) align with/drive long-term objectives (strategic)?
- C. What are the major milestones in these tactical and strategic objectives?
- D. What are major challenges to achieving those objectives/milestones?
- E. How does expected performance relate to the current business outlook?

## Human Capital

- A. What is your human resources strategy and how does it align with the corporate strategy?
- B. Does the plan you are considering support the broader HR strategy?
- C. How competitive is your industry for human capital?
  - i. Do you anticipate economic conditions that might affect your competitive posture for human capital?

- D. What is the availability of critical talent in your industry?
- E. Do competitiveness and availability of critical talent vary by business unit?
- F. What is the current employer-employee value proposition?
  - i. Do you anticipate economic conditions that might affect your employee value proposition?
- G. What is your company's philosophy regarding employee mobility and how does this affect plan design?

## Compensation Philosophy

- A. What is the compensation philosophy and objectives?
  - i. Market orientation
  - ii. Target pay position (total and key elements)
    - a. Are you going to position consistently within each business unit?
    - b. Is your target pay position sustainable in a severe economic downturn?
    - c. If not, how will your target pay position be modified in weak economic periods?
  - iii. Performance leverage of compensation
    - a. Have you assessed your programs for unnecessary and excessive risk?
  - iv. Performance perspective (corporate vs. division)
  - v. Peer groups
    - a. Is the peer group consistent between business units?
  - vi. Does this fit within total rewards philosophy/strategy?
- B. To what degree does the compensation philosophy align with corporate strategy, corporate culture, organizational resources?
- C. Are current compensation programs aligned with the philosophy? If not, why not?
- D. How effective is the compensation philosophy?
  - i. Is your compensation philosophy sustainable in a severe economic downturn?
- E. Do divisions across your company compete for talent? If so, do they compete equitably or do pay packages vary considerably?
- F. How is compensation perceived by employees (fairness, reasonableness)?
- G. What effect would the proposed plan have on total compensation opportunity?



## Talent Attraction/Retention/Development

- A. What is the organization's philosophy regarding attraction, motivation, retention?
- B. How effective is the organization at attracting and retaining talent?
- C. How does compensation affect employee engagement?
- D. How will the program support the recruitment of critical talent/hot skills?
- E. How will the program support the retention of critical talent/hot skills?
- F. How will the program support talent development?

## Infrastructure

- A. Do you have measurement systems that will provide the performance metrics you need for your new program?
- B. Do you have the necessary systems to operationalize and administer this program?
- C. Do you have the ability to audit the administrative effectiveness of this program?
- D. Is your financial reporting/accounting function capable of administering this program?

## Organizational Culture

- A. What degree of change in compensation programs will the organization accept?
- B. Are there key stakeholders or influencers (HR, legal, tax) that need to be part of the program development process?
- C. Do you have a performance focus or entitlement orientation in your compensation programs?
- D. If you do have a performance orientation is it individual- or team-based?
- E. Does it vary by business unit?

## Global

- i. Are there any additional cultural considerations for introducing this program in other countries?
- ii. Are there cultural issues that will interfere with the program's effectiveness?
- iii. How can these issues be mitigated or managed?
- iv. Will the program deliver the desired results across the countries in which your company operates?

- vi. Will international economic conditions affect the organization's readiness for change?

## **Organizational Resources & Parameters**

### **Legal**

- A. To what extent is the legal department involved in compensation planning, design, administration and disclosure?
- B. Have you had legal issues with plans of this type in the past?
- C. To what extent will existing legal obligations affect your plan design?
- D. Are there current legal issues and/or company litigation issues that may affect plan design?
- E. Is the legal department comfortable with this design in the current legal/regulatory environment?
- F. Is your legal department prepared to support any special reporting requirements for this program?

### **Finance/Accounting**

- A. What is the role of finance/accounting in plan design?
- B. Has your accounting division reviewed this program design from an accounting treatment perspective?
- C. Do you know what financial constraints may affect program design?
  - i. Authorized share capital
  - ii. Current burn rate
  - iii. Overhang
  - iv. Dilution
  - v. Self-funding
  - vi. Internal hurdle rate of return
  - vii. Cash-flow requirements
  - viii. Severe economic downturn
  - ix. Impact of currency fluctuations
- D. Will your finance department accept plan/program volatility?
  - i. Would increased economic volatility change finance's view of the new plan?
- E. Is your finance/accounting department prepared to support any special reporting requirements for this program?

## Tax

- A. What is the role of the tax department in plan design?
- B. How risk-tolerant is your tax department?
- C. What are the tax implications for the company in your proposed plan design?
  - i. Can anticipated taxes be minimized for the company through design changes?
- D. What is the anticipated tax impact of this program on program participants?
  - i. Are participants aware of this anticipated tax impact?

## Global

- i. Do the tax implications vary across countries?
- ii. How can these issues be mitigated/managed?

## Investor Relations

- A. What is the process for developing responses and communicating with shareholders?
- B. What are your governance ratings and what impact do they bring to bear on design?

# Stakeholders

Stakeholders include individuals or organizations that have a financial interest in the company and whose interests must be considered when designing a compensation plan.

## Shareholders

- *Is this program required to be approved by the shareholders? If not, skip this section.*
- A. Who are the shareholders (institutional, employees, union, etc.) and what are their interests and concerns?
- B. What are shareholder expectations about your compensation programs, and how do they affect plan design?
- C. How do shareholders react to suggested voting guidelines from external groups (ISS, labor unions)?
- D. What is the likely perspective of these shareholder advocates on this program or issue?
  - i. Would shareholder advocates have a different view of this program in a severe economic downturn?
- E. How do shareholders react to media coverage of hot-button issues?
- F. What is your organization's shareholder proposal process?
- G. What have been the major proxy challenges? By whom have you been challenged?
- H. What have the outcomes of the challenges been, in terms of votes?
- I. How and when will you disclose this plan to shareholders (proxy, 10Q/10K)?
  - i. Would this disclosure process be modified in a severe economic downturn?

## Compensation Committee/Board of Directors

- *Is this program required to be reviewed by the compensation committee of your board of directors? If not, skip this section.*

- A. Has the committee reviewed similar compensation programs or issues in the past?
- B. If so, what was the outcome of that review?
- C. Has the committee been adequately prepared to discuss this program or issue in previous meetings?
- D. If not, can the committee review and consider this program or issue in a single meeting?
- E. Are committee members familiar with similar programs or issues?
  - i. From their respective companies?
  - ii. From other compensation committees?
- F. Do you know what questions committee members are likely to ask regarding your program or issue?
- G. Do you know committee perspectives on this program or issue?
- H. Does the committee employ an independent compensation consultant?
- I. What is the role of the compensation committee consultant?
- J. Has the committee consultant been briefed about the proposed program or issue?
- K. Do you know the consultant's views regarding this program design or issue?
- L. Are there other advisers to the committee and what are their perspectives?
- M. Has the board's external adviser received the same materials as the committee, and has he/she had sufficient time to review them?
- N. Do you have necessary backup materials to answer any questions that might be raised in the committee meeting?
- O. What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?
  - i. How can you use these (or create new tools) to support decision making on this program?

## Management

- A. What is the anticipated management decision-making process for the program or issue?
- B. Who on the senior management team needs to know about this program or issue?
  - i. What specifically do they need to know?
- C. Who is typically the influencer, decision maker or derailer of similar decisions within the company?

- D. Do you have an executive sponsor or champion for this program or issue?
- E. What is your plan or process to develop support for the desired outcome?
- F. Will this program or issue be considered a sensitive topic for your senior management team?
  - i. Have they considered similar issues in the past?
  - ii. What was the outcome of previous considerations?

## Plan Participants

- A. Who will participate in, or be affected by, this program?
  - i. What are the participants' needs and how do programs address those needs?
  - ii. Would participants' program needs be different in a severe economic downturn?
  - iii. What is your proposed process to gather this information?
- B. Will participants have a "say" in the design of this program or issue resolution?
- C. Are there opinion leaders within the participant group?
  - i. How will you ensure the buy-in of these opinion leaders?
  - ii. Will you consult these leaders during the design phase or only during communication phase?
- D. Are there one-off programs/benefits, or deals that will affect compensation program design for those individuals?
- E. How have past and current plans been received?
- F. Will this program have a negative effect on other programs?
  - i. If so, can this negative impact be mitigated through plan design?

## Other Employees

- A. Will the general employee population be advised about this program?
  - i. If not, is there any risk of nondisclosure?
    - a. Would the risk of nondisclosure increase in a severe economic downturn?
  - ii. If so, when and how will they be advised?
- B. What type of compensation and benefits treatment have other employees recently received?
  - i. Have they recently been asked to give up or receive reduced compensation or benefits?



- C. Will they perceive this program as fair?
  - i. Would a severe downturn in the economy or company performance change their view of this program's fairness?

### **Communication Strategy**

- A. What is your proposed communication strategy?
  - i. Who needs to know what (management, participants, other employees)?
  - ii. What communication channels will you use (face-to-face, print, Web)?
  - iii. Who will be the primary communicators of the new program?
    - a. Will they have credibility with participants?
  - iv. What are formal/informal communication processes?
  - v. Would a severe economic downturn necessitate a change to this communication strategy?
- B. Is senior management prepared to support and communicate this program or issue?
- C. Have you allowed adequate time for discussions?



### **Global**

- i. Will there be implications/requirements for translating materials?
- ii. How will communications be tailored to cultural sensitivities in each country?

# External Environment

The external environment includes factors outside of an organization's control that affect how a company may operate its business and are essential to consider when designing compensation plans.

## Regulatory

### Regulatory Bodies

- A. What regulatory jurisdictions are you subject to?
- B. Are the regulations consistent or in conflict with one another?
- C. Does this program require approval by external regulatory bodies?
- D. What is the anticipated process to submit this program for approval?
- E. What is the anticipated timeline for program approval?
- F. Is it clear which jurisdiction will have final approval?
- G. What are the anticipated reactions of current regulators to this program?
  - i. Would a severe economic downturn affect regulators' view of this program?
- H. How have they historically responded to programs of this type?

### Regulatory Compliance

- A. What regulations govern the type of program you are designing?
- B. Are there processes in place to track compliance?
- C. Does the cost of compliance substantially erode the benefit delivered?
- D. What is the potential impact of any anticipated legislation on programs of this type?

### Global

- i. Will this program be subject to global regulation in the company's area of operations?
- ii. Does it conflict with regulations in any participating country?
- iii. Can/should the program be modified to comply with regulations in those countries?

## Accounting Treatment

- A. What is the current accounting treatment for this program?
  - i. Will this treatment have a negative effect on your company?
  - ii. Can any negative impacts be mitigated through program design?
- B. Are there anticipated accounting changes on the horizon that could affect the current accounting treatment for your program?
  - i. Can any of the anticipated changes be mitigated through program design?

## Global

- A. Does the accounting treatment differ from country to country?
  - i. Will this treatment have a negative impact on your company?
  - ii. Can any negative effects be mitigated through program design?
- B. Are there anticipated accounting changes on the horizon that could affect the current accounting treatment for your program?
  - i. Can any of the anticipated changes be mitigated through program design?

## Tax

- A. What is the current tax treatment for this program?
  - i. Will this treatment have a negative effect on your company?
  - ii. Can any negative effect be mitigated through program design?
- B. Are there anticipated tax changes on the horizon that could affect the current tax treatment for your program?
  - i. Can any of the anticipated changes be mitigated through program design?

## Global

- i. What are the tax implications of this program for the company and employees in participating countries?
- ii. Are there any other considerations (e.g., eligibility, entitlement issues, representation)?

## Legal

- A. What legal requirements/jurisdictions do you need to consider when designing this plan?
- B. What are the reporting requirements of these jurisdictions for your plan?
- C. Are these current requirements anticipated to change in the near future?

## Global

- i. What legal requirements/jurisdictions in the countries in which your company operates do you need to consider when designing this plan?
- ii. What are the reporting requirements of these jurisdictions for your plan?
  - a. Are these current requirements anticipated to change in the near future?

## **Economic/Industry/Labor Market**

### **Economic Trends**

- A. What are the current economic conditions for your company/industry?
- B. Are economic trends improving or declining?
- C. How cyclical/volatile is the industry?
- D. How do current economics affect compensation planning?
- E. How will your proposed program react in the current economic forecast?
- F. What negative economic results would cause this program not to fund/payout in the first year?
  - i. What is the probability that these negative results will occur in the first year of this program?

## Global

- i. What are the current economic conditions for your company/industry in the countries in which your company operates?
- ii. Are economic trends improving or declining?
- iii. How do current economics affect compensation planning?
- iv. How will your proposed program react in the current economic forecast?
- v. What negative economic results would cause this program not to fund/payout in the first year?
- vi. What is the probability that these negative results will occur in the first year of this program?

### **Industry Trends**

- A. What is the degree of consolidation in your industry?
- B. Is this trend accelerating or declining?
- C. What is the likelihood of change of control?
- D. What is the likelihood of a major acquisition or divestiture?
- E. How do these affect your compensation plan design?

## Labor Market Trends and Pay Practices

- A. What are the current demand/supply characteristics of your labor market?
  - i. Is a particular skill set or expertise in especially high demand at present?
- B. What are market pay practices?
- C. How reliable and accurate is compensation market data for programs of this type?
- D. Do you need to develop alternate sources of data?
- E. To what extent do you want to match or differ from market pay practices?
  - i. Do you need to pay a premium for a particular skill set or expertise?
  - ii. If new/unusual, will it help create a competitive advantage for your company in attracting/retaining human capital?
  - iii. How quickly will market leaders react to imitate your program?

## Community

### Media

- A. Will this information become public knowledge?
- B. Have you alerted your communications department that this plan may elicit media scrutiny?
  - i. What is the likelihood the media will focus on this program?
  - ii. How do you anticipate the media will react to this program?
    - a. Would a severe economic downturn alter the media's view of this program?
  - iii. Will media reaction affect your plan design?
  - iv. Will media reaction affect the timing of your announcement?

### Special Interest Groups

- A. Are there special interest groups that will react to this plan design?
  - i. How have they reacted to similar programs?
- B. Should any of these concerns be mitigated through plan design changes?
- C. Can opposition by these interest groups have a broader impact on your company?
- D. Have you alerted the appropriate resources (legal, government relations) within the company that this plan may elicit special interest group scrutiny?
  - i. What is the likelihood that special interest groups will focus on this program?

- a. Would a severe economic downturn lead to a different/stronger focus on this program?
  - ii. How do you anticipate special interest groups will react to this program?
- E. Will special interest groups' reaction affect your plan design?
- F. Will special interest groups' reaction affect the timing of your announcement?

### **Socio-Political Environment**

- A. Are there particular communities/social or political activists that will react to this plan?
- B. What are the sensitivities of the communities or governmental bodies or entities in which the company operates (living wage, executive pay, highest-to-lowest ratio, layoffs, divestiture)?
  - i. Would a severe economic downturn increase sensitivities to this program for community or governmental bodies?
- C. Can the company's lobbyists influence the community or governmental bodies to view this program positively?
- D. Should these sensitivities be mitigated through program design changes?
- E. Have you alerted the appropriate resources (community/media relations/governmental affairs) within the company that this plan may elicit communities'/social or political activists' scrutiny?
  - i. What is the likelihood communities/social or political activists will focus on this program?
  - ii. How do you anticipate communities/social or political activists will react to this program?
  - iii. Will communities'/social or political activists' reactions affect your plan?
  - iv. Will communities'/social or political activists' reactions affect the timing of your announcement?



# Disclosure & Transparency

Disclosure and transparency includes regulatory requirements and an organization's philosophy regarding the extent to which an it provides complete and easily understandable compensation information.

## Public Disclosure/Transparency

- A. Have you met with appropriate internal and/or external resources (legal, tax, accounting, audit, HR, shareholder relations, consultant, other) to identify and address disclosure requirements?
  - i. What are the disclosure requirements for this program (SEC, FASB, IRS, DOL, other)?
  - ii. Are these disclosure requirements different by agency?
  - iii. How do the requirements differ by plan type?
  - iv. How do the requirements differ by employee group?
  - v. What is the effect of disclosure requirements on this program (company, legal, executive, tax, investor relations)?
  - vi. Should any disclosure issues be mitigated by plan design changes?
- B. What transparency trends are emerging in your industry?
- C. What is the company's position on appropriate level of transparency (disclosing more than is required, simplification of written communications)?
  - i. What is the appropriate level of disclosure for the various constituents, taking into consideration proprietary information, confidentiality, competitive advantage/risk?

## Global

- i. How do public disclosure/transparency requirements differ by country?
- ii. Will there be additional documentation requirements?

## Regulatory Filings

- A. Have you met with appropriate internal and/or external resources (legal, accounting, HR, shareholder relations, consultant, other) to prepare the proxy?

- B. What is the company's philosophy regarding transparent disclosure in the proxy statement (e.g., minimally compliant versus full disclosure and effective communications)?
  - i. Have you provided the context/rationale for why certain elements exist in the program and others don't?
  - ii. Do you want to provide more information than required?
  - iii. Do you want to consider disclosing what you do not offer your executives?
  - iv. Is information communicated consistent year-to-year in order to maximize shareholder understanding?
  - v. Does the compensation, discussion and analysis (CDA) letter clearly link compensation programs to the business strategy?

### **Compensation Committee**

- A. Does the charter of the compensation committee require approval of this plan? If so:
  - i. Have they reviewed similar plans in the past?
  - ii. What was their reaction?
- B. What are sensitive committee issues that might raise concern with this plan?

# Applying the Questionnaire in the Real World

A Supplement to the *WorldatWork Executive Rewards Questionnaire*  
February 2008

**Editor's Note:** This supplement, developed by Diane Vavrsek, an HR graduate student at Cornell University, was funded by the WorldatWork Sponsored Research program.

This supplement responds to a question that has been posed since the questionnaire was published: Would the use of this unique tool have had any effect on some of the highly-publicized and embarrassing executive compensation situations of the past decade? The simple answer, based on what follows here, is yes.

This supplement has been designed to illustrate specific, real-world corporate examples of how compensation plans may have differed had the questionnaire been consulted. This supplement to the *WorldatWork Executive Rewards Questionnaire* includes 10 case studies taken straight from the headlines of the past 10 years. As in the questionnaire itself, the questions contained here are grouped into four primary areas: internal environment, external environment, stakeholders and disclosure and transparency.

# Case Study: Fannie Mae

## Situation

In late 2004, both the CEO and CFO stepped down after the company restated earnings by roughly \$10 billion due to accounting irregularities. The departures were publicly referred to as “retirements.” The CEO and CFO received the same severance and retirement packages they would have had they left with unflawed performance records.

### Internal Environment

- How is compensation perceived by employees (fairness, reasonableness)?
- To what extent is the legal department involved in compensation planning, design, administration and disclosure?

### External Environment

- Can opposition by interest groups have a broader effect on your company?
- Have you alerted the appropriate resources (community/media relations/governmental affairs) within the company that this plan may elicit communities’/social or political activists’ scrutiny?
- Are there particular communities/social or political activists that will react to this plan?
- How do you anticipate the media will react to this program?

### Stakeholders

- Has the committee consultant been briefed about the proposed program or issue?
- Will other employees perceive this program as fair?

### Disclosure & Transparency

- Have you met with appropriate internal and/or external resources (legal, tax, accounting, audit, HR, shareholder relations, consultant, other) to identify and address disclosure requirements?

## **Situation (continued)**

The executive compensation program approved by the board included a special option program that granted options to executives that immediately vested once an earnings-per-share goal was met.

The board also gave the freedom to executives to sell vested options and shares at any time, allowing the CFO to collect on the sale of his shares despite the restatement of earnings.

### **Internal Environment**

- How does expected performance relate to the current business outlook?
- What are the results that need to be achieved in the short and long term?
- Is the legal department comfortable with this design in the current legal/regulatory environment?

### **External Environment**

- Will this information become public knowledge?

### **Stakeholders**

- What are shareholder expectations about your compensation programs, and how do they affect plan design?
- Is senior management prepared to support and communicate this program or issue?
- What is the likely perspective of shareholder advocates on this program or issue?
- How and when will you disclose this plan to shareholders (proxy, 10Q/10K)?
- Has the committee consultant been briefed about the proposed program or issue?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- Will the general employee population perceive this program as fair?
- Are compensation committee members/board of director members familiar with similar programs or issues?
- What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?

## **Disclosure & Transparency**

- Have you provided the context/rationale for why certain elements exist in the program and others don't?

## **Situation (continued)**

In 2004, Fannie Mae chose not to disclose the total value of the CEO and CFO retirement packages in its annual proxy statements.

### **External Environment**

- Are there special interest groups that will react to this plan design?
- Are there particular communities/social or political activists that will react to this plan?
- Will this information become public knowledge?

### **Stakeholders**

- How and when will you disclose this plan to shareholders (proxy, 10Q/10K)?

### **Disclosure & Transparency**

- What is the company's philosophy regarding transparent disclosure in the proxy statement (e.g., minimally compliant versus full disclosure and effective communications)?
- What is the company's position on appropriate level of transparency (disclosing more than is required, simplification of written communications)?

Citation: Bebchuk and Fried, 2005



# Case Study: Computer Associates Inc.

## Situation

The CEO and other executives of Computer Associates were granted board and shareholder approval in 1995 for an executive compensation plan that allowed executives to collect stock grants if the common stock price maintained a given price for 60 days. In early 1998 the stock did, and the executives collected their shares. Shortly after collecting their grants, the company announced that its revenue estimates were to be reduced by \$100 million for the next two quarters. The stock lost two-thirds of its value the next day.

### Internal Environment

- How does expected performance relate to the current business outlook?
- What are the results that need to be achieved in the short and long term?

### External Environment

- What are the current economic conditions for your company/industry?
- Are economic trends improving or declining?
- What negative economic results would cause this program not to fund/payout in the first year?
- Are there particular communities/social or political activists that will react to this plan?
- To what extent do you want to match or differ from market pay practices?
- How do you anticipate the media will react to this program?

### Stakeholders

- What is the likely perspective of shareholder advocates on this program or issue?
- Will the general employee population perceive this program as fair?

## Situation (continued)

The plan failed to include a provision that adjusted the number of shares issued after accounting for stock splits and other changes in the organization's capital structure. One source indicated this could have been avoided if appropriate people had developed the contract language.

### Internal Environment

- What is the role of finance/accounting in plan design?
- Has your accounting division reviewed this program design from an accounting treatment perspective?
- Is the legal department comfortable with this design in the current legal/regulatory environment?

### Stakeholders

- What is the likely perspective of shareholder advocates on this program or issue?
- Does the compensation committee employ an independent compensation consultant?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- Are compensation committee members/board of director members familiar with similar programs or issues?

## Situation (continued)

The cash bonus-to-salary ratio was unusually high for a company with average performance, such as Computer Associates. At the time, high performing software companies generally had a ratio of 1:3 but Computer Associates had a ratio of 1:5.

### Internal Environment

- What is the compensation philosophy and objectives? What about market orientation and peer groups?

### External Environment

- What are market pay practices?

### Stakeholders

- Is senior management prepared to support and communicate this program or issue?

Citation: Roberts, 2000

# Case Study: New York Stock Exchange

## Situation

In May 2004, New York attorney general files a lawsuit against the former CEO and a former director of the New York Stock Exchange (NYSE). The suit was for violation of New York's Not-for-Profit Corporation Law relating to "reasonable" compensation. The CEO's retirement plan built to more than \$139.5 million during his 36-year tenure. He was also due to receive \$48 million in deferred pay over the next four years.

### External Environment

- What regulatory jurisdictions are you subject to?
- Have you alerted the appropriate resources (community/media relations/governmental affairs) within the company that this plan may elicit communities'/social or political activists' scrutiny?
- What regulations govern the type of program you are designing?
- Are there particular communities/social or political activists that will react to this plan?
- How do you anticipate the media will react to this program?

### Stakeholders

- Has the committee been adequately prepared to discuss this program or issue in previous meetings?
- Does the committee employ an independent compensation consultant?
- What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?

### Disclosure & Transparency

- What is the company's position on appropriate level of transparency (disclosing more than is required, simplification of written communications)?

## **Situation (continued)**

The compensation committee set the CEO's compensation based upon two factors:

- Median compensation paid to CEOs of a select group of peers
- Assessment of NYSE performance.
- But many of the companies chosen for comparison were not comparable in size, revenue or complexity. In addition, the CEO allegedly picked the members of the compensation committee, whose companies were often listed on the exchange.

### **Internal Environment**

- To what degree does the compensation philosophy align with corporate strategy, culture and organizational resources?
- What are the results that need to be achieved in the short and long term?

### **External Environment**

- What are market pay practices?
- To what extent do you want to match or differ from market pay practices?
- Will this information become public knowledge?

### **Stakeholders**

- If the committee has not been adequately prepared, can the committee review and consider this program or issue in a single meeting?
- Are committee members familiar with similar programs or issues?
- Has the committee been adequately prepared to discuss this program or issue in previous meetings?
- Does the committee employ an independent compensation consultant?
- Will the general employee population perceive this program as fair?
- What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?

### **Disclosure & Transparency**

- Have you provided the context/rationale for why certain elements exist in the program and others don't?

## **Situation (continued)**

In the lawsuit, the director was charged with “misleading the NYSE board about the amount of annual compensation the committee was recommending to be approved by the board.”

### **Stakeholders**

- Has the committee been adequately prepared to discuss this program or issue in previous meetings?
- Does the committee employ an independent compensation consultant?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- Are compensation committee members/board of director members familiar with similar programs or issues?
- What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?

Citation: Penski, 2005

# Case Study: WorldCom

## Situation

Between 2000 and 2002 WorldCom CEO Bernard Ebbers obtained unsecured loans amounting to 20 percent of the firm's cash, allegedly at interest rates well below the market rates for large margin loans. Upon leaving the organization, Ebbers still owed \$408 million.

WorldCom subsequently entered bankruptcy and the share price dropped dramatically. Ebbers was then unable to pay back the loan by selling his shares, as he had allegedly planned.

### Internal Environment

- Do you have the necessary systems to operationalize and administer this program?
- Are there key stakeholders or influencers (HR, legal, tax) that need to be part of the program development process?
- Is your finance/accounting department prepared to support any special reporting requirements for this program?
- What are your governance ratings?
- What is the role of finance/accounting in plan design?
- Do you know what financial constraints may affect program design?
- What are your key business objectives and strategic drivers?
- To what extent is the legal department involved in compensation design, administration and disclosure?
- What are the results that need to be achieved in the short and long term?
- Is the legal department comfortable with this design in the current legal/regulatory environment?

### External Environment

- What is the current accounting treatment for this program?

- What regulatory jurisdictions are you subject to?
- What regulations govern the type of program you are designing?
- Are there particular communities/social or political activists that will react to this plan?
- To what extent do you want to match or differ from market pay practices?

### **Stakeholders**

- Will this program have a negative effect on other programs?
- Will the general employee population perceive this program as fair?

### **Disclosure & Transparency**

- Have you met with appropriate internal and/or external resources (legal, tax, accounting, audit, HR, shareholder relations, consultant, other) to identify and address disclosure requirements?
- Have you provided the context/rationale for why certain elements exist in the program and others don't?
- What is the company's position on appropriate level of transparency (disclosing more than is required, simplification of written communications)?

## **Situation (continued)**

If the compensation committee had secured the loans, Ebberts' shares might have been seized in order to sell them to cover the loan when the stock price was still high enough to do so.

### **Internal Environment**

- To what extent is the legal department involved in compensation planning, design, administration and disclosure?

### **Stakeholders**

- Has the committee been adequately prepared to discuss this program or issue in previous meetings?
- Does the committee employ an independent compensation consultant?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- Are compensation committee members/board of director members familiar with similar programs or issues?

- What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?

Citation: Bebchuk and Fried, 2004



# Case Study: Walt Disney Co.

## Situation

In 2003, Walt Disney Co. shareholders filed a lawsuit relating to the \$140 million severance package paid to former the president. Shareholders contended that the directors knowingly or intentionally “breached their fiduciary duty of due care in approving (the president’s) employment agreement,” and failed to consider the terms of the termination — which was allegedly negotiated exclusively by the CEO.

Although the court agreed with shareholders that the CEO had exclusively negotiated the deal and orchestrated the president’s hire without input from the board of directors, it found that neither he nor the other directors breached their fiduciary duty.

### Internal Environment

- What is the process for developing responses and communicating with shareholders?
- To what degree does the compensation philosophy align with corporate strategy, culture and organizational resources?

### Stakeholders

- What are shareholder expectations about your compensation programs and how do they affect program design?
- How and when will you disclose this plan to shareholders?
- Has the committee consultant been briefed about the proposed program or issue?
- Has the committee been adequately prepared to discuss this program or issue in previous meetings?
- Are compensation committee members/board of director members familiar with similar programs or issues?

### Disclosure & Transparency

- What is the company’s position on appropriate level of transparency

(disclosing more than is required, simplification of written communications)?

### **Situation (continued)**

The court did, however, “criticize the members of the compensation committee for not doing more to inform themselves of the terms of Ovitz’s employment agreement and to become involved in the review and approval process.

#### **Internal Environment**

- Has the committee consultant been briefed about the proposed program or issue?

#### **External Environment**

- Are there particular communities/social or political activists that will react to this plan?
- To what extent do you want to match or differ from market pay practices?
- Will this information become public knowledge?
- How do you anticipate the media will react to this program?

#### **Stakeholders**

- Is senior management prepared to support and communicate this program or issue?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- Are compensation committee members/board of director members familiar with similar programs or issues?
- What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?

Citation: Brossman and Weiss, 2005

# Case Study: The Home Depot

## Situation

In 2000, the new CEO of The Home Depot entered into an employment contract that eventually awarded him more than \$200 million during a five-year period. A portion of this amount was given to the CEO in the form of a guaranteed annual bonus of at least \$3 million a year. The provision of a guaranteed minimum annual bonus is considered rare by industry standards — a study by the Delves Group indicates that The Home Depot CEO was the only CEO of the 200 largest U.S. revenue companies to have such an agreement. While examples of guaranteed payment exist, the length and size of the payments is considered uncommon.

### Internal Environment

- How does expected performance relate to the current business outlook?
- What are the results that need to be achieved in the short and long term?

### External Environment

- What is the likely perspective of shareholder advocates on this program or issue?
- Has the committee consultant been briefed about the proposed program or issue?
- Are there particular communities/social or political activists that will react to this plan?
- To what extent do you want to match or differ from market pay practices?
- Will this information become public knowledge?
- How do you anticipate the media will react to this program?
- To what extent do you want to match or differ from market pay practices?

### **Stakeholders**

- Is senior management prepared to support and communicate this program or issue?
- Have you alerted the appropriate resources (community/media relations/governmental affairs) within the company that this plan may elicit communities'/social or political activists' scrutiny?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- Are compensation committee members/board of director members familiar with similar programs or issues?

### **Disclosure & Transparency**

- What is the company's position on appropriate level of transparency (disclosing more than is required, simplification of written communications)?

### **Situation (continued)**

In 2005, the CEO received his guaranteed bonus while the amount of money allotted to the nonsalaried employee bonus program decreased by 50 percent.

#### **External Environment**

- Will this information become public knowledge?

#### **Stakeholders**

- How and when will you disclose this plan to shareholders (proxy, 10Q/10K)?
- Will the general employee population perceive this program as fair?

#### **Disclosure & Transparency**

- What is the company's philosophy regarding transparent disclosure in the proxy statement (e.g., minimally compliant versus full disclosure and effective communications)?

Citation: Grow, 2006

# Case Study: Enron Corp.

## Situation

In the late 1990s and into 2001, Enron Corp. provided its executives with compensation packages that included equity stakes in business units. Although many companies use equity in rewards programs, the amounts provided to Enron executives were unusually large (greater than 5 percent) and not tied to long-term performance because executives were allowed to convert their equity into either common stock or receive cash. The CEO and president of a subsidiary received more than \$310 million by converting equity stakes into cash.

### Internal Environment

- What is your corporate strategy?
- What are your key business objectives and strategic drivers?
- How do these short-term objectives (tactical) align with/drive long-term objectives (strategic)?
- What are major challenges to achieving strategic objectives/milestones?
- Do you know what financial constraints may affect program design?
- How does expected performance relate to the current business outlook?
- Has your accounting division reviewed this program design from an accounting treatment perspective?
- What are the results that need to be achieved in the short and long term?
- Is the legal department comfortable with this design in the current legal/regulatory environment?

### External Environment

- Are there particular communities/social or political activists that will react to this plan?

- To what extent do you want to match or differ from market pay practices?
- Will this information become public knowledge?
- How do you anticipate the media will react to this program?

### **Stakeholders**

- What is the likely perspective of shareholder advocates on this program or issue?
- Has the committee been adequately prepared to discuss this program or issue in previous meetings?
- Does the committee employ an independent compensation consultant?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- Are compensation committee members/board of director members familiar with similar programs or issues?

### **Situation (continued)**

In addition to the equity stakes, Enron rewarded two executives large cash bonuses of \$54 million and \$42 million.

#### **Internal Environment**

- Do you know what financial constraints may affect program design?
- What are your key business objectives and strategic drivers?

#### **External Environment**

- Will the general employee population perceive this program as fair?
- To what extent do you want to match or differ from market pay practices?
- How do you anticipate the media will react to this program?

#### **Disclosure & Transparency**

- What is the company's philosophy regarding transparent disclosure in the proxy statement (e.g., minimally compliant versus full disclosure and effective communications)?

### **Situation (continued)**

The chairman/chief executive of a subsidiary allegedly received a 20-percent stake in his unit, thus becoming a minority owner. He eventually converted his stake into more than \$20 million in cash before leaving the company. The executive's stake, however, was not listed on any company's proxy filings, despite the fact that the stake diluted the value of the shareholders' investments.

### **Internal Environment**

- Has your accounting division reviewed this program design from an accounting treatment perspective?
- Is the legal department comfortable with this design in the current legal/regulatory environment?

### **External Environment**

- To what extent do you want to match or differ from market pay practices?

### **Stakeholders**

- Has the board's external adviser received the same materials as the committee, and has he/she had sufficient time to review them?
- How and when will you disclose this plan to shareholders?
- Does the committee employ an independent compensation consultant?
- What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?

### **Disclosure & Transparency**

- Have you met with appropriate internal and/or external resources (legal, accounting, HR, shareholder relations, consultant, other) to prepare the proxy?
- Have you met with appropriate internal and/or external resources (legal, tax, accounting, audit, HR, shareholder relations, consultant, other) to identify and address disclosure requirements?
- What is the company's philosophy regarding transparent disclosure in the proxy statement (e.g., minimally compliant versus full disclosure and effective communications)?
- What is the company's position on appropriate level of transparency (disclosing more than is required, simplification of written communications)?

Citation: Berthold and Leopold, 2002

# Case Study: GE

## Situation

In 2002, the details of the former CEO's retirement package was revealed in a divorce court filing. The CEO's wife claimed that he had received approximately \$2.5 million in benefits during the prior year, including use GE aircraft for personal travel, use of a New York City apartment, use of a chauffeured limousine, office space in New York City and Connecticut, estate and tax advisers, a personal assistant, a communications system and other benefits. The former CEO subsequently asked GE to modify the contract and eliminate everything except the office and administrative support, which had been standard for all retired GE chairmen.

### External Environment

- Have you alerted the appropriate resources (community/media relations/governmental affairs) within the company that this plan may elicit communities'/social or political activists' scrutiny?
- Have you met with appropriate internal and/or external resources (legal, tax, accounting, audit, HR, shareholder relations, consultant, other) to identify and address disclosure requirements?
- Are there particular communities/social or political activists that will react to this plan?
- To what extent do you want to match or differ from market pay practices?
- Will this information become public knowledge?
- How do you anticipate the media will react to this program?

### Stakeholders

- Will this program or issue be considered a sensitive topic for your senior management team?
- What is the likely perspective of shareholder advocates on this program or issue?



- Has the committee consultant been briefed about the proposed program or issue?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- Are compensation committee members/board of director members familiar with similar programs or issues?

### **Situation (continued)**

After the details of the retirement benefits were revealed, the SEC announced an informal investigation, with an allegation that the company failed to fully disclose the scope of the plan. The company contended that it had provided appropriate information about the CEO's perquisites in its proxy statements and annual reports from 1997-2002, but the SEC concluded that investors were unable to learn the specifics of the benefits. Subsequent to the SEC decision, none of the five highest compensated officers listed in the 2004 proxy statement had employment or retirement contracts.

#### **Stakeholders**

- How and when will you disclose this plan to shareholders (proxy, 10Q/10K)?
- What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?

#### **Disclosure & Transparency**

- What is the company's philosophy regarding transparent disclosure in the proxy statement (e.g., minimally compliant versus full disclosure and effective communications)?
- Have you provided the context/rationale for why certain elements exist in the program and others don't?
- What is the company's position on appropriate level of transparency (disclosing more than is required, simplification of written communications)?

Citation: CBS News, 2002, and Milwaukee Business Journal, 2004

# Case Study: UnitedHealth Group

## Situation

The CEO of UnitedHealth Group retired in 2006 after receiving more than \$2 billion in stock options during his tenure, allegedly by picking the lowest stock price each year for his annual options grants. In March 2007, UnitedHealth restated earnings by \$1.13 billion over a 12-year period.

### Internal Environment

- What are your key business objectives and strategic drivers?
- Has your accounting division reviewed this program design from an accounting treatment perspective?
- Is the legal department comfortable with this design in the current legal/regulatory environment?

### External Environment

- What regulatory jurisdictions are you subject to?
- What regulations govern the type of program you are designing?
- Will this information become public knowledge?
- How do you anticipate the media will react to this program?

### Stakeholders

- Who are the shareholders (institutional, employees, union, etc.) and what are their interests and concerns?
- What are shareholder expectations about your compensation programs, and how do they affect plan design?
- How and when will you disclose this plan to shareholders?
- Has the committee consultant been briefed about the proposed program or issue?
- Has the committee been adequately prepared to discuss this program or issue in previous meetings?
- Will the general employee population perceive this program as fair?

## Situation (continued)

It has been alleged that the CEO had made personal investments with the former chair of the compensation committee. The chair of the compensation committee resigned on the same day as the CEO retired.

### External Environment

- What regulations govern the type of program you are designing?
- Are there particular communities/social or political activists that will react to this plan?
- Will this information become public knowledge?
- How do you anticipate the media will react to this program?

### Stakeholders

- Is senior management prepared to support and communicate this program or issue?

### Disclosure & Transparency

- What is the company's philosophy regarding transparent disclosure in the proxy statement (e.g., minimally compliant versus full disclosure and effective communications)?
- What is the company's position on appropriate level of transparency (disclosing more than is required, simplification of written communications)?

## Situation (continued)

After the CEO's departure, the board adopted a number of reforms, including creation of a non-executive chairman, a chief ethics officer, and the elimination of severance in connection with change in control.

### Stakeholders

- Does the committee employ an independent compensation consultant?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- What tools and processes are in place to support compensation committee decision making?
- Are compensation committee members/board of director members familiar with similar programs or issues?

Citation: *The Wall Street Journal*, 2006, and UnitedHealth Group, 2006

# Case Study: KB Home

## Situation

The CEO of KB Home departed in 2006 after an internal investigation revealed that he had backdated his own stock options. The company's internal investigation indicated that the CEO and head of HR had probably altered the dates of stock option grants between 1998 and 2005. As a result of the backdating, the company indicated a need to restate more than three years of financial results and incur an additional compensation expense of more than \$41 million.

### Internal Environment

- To what extent is the legal department involved in compensation planning, design, administration and disclosure?
- Has your accounting division reviewed this program design from an accounting treatment perspective?
- What are the results that need to be achieved in the short and long term?
- Is the legal department comfortable with this design in the current legal/regulatory environment?

### External Environment

- What regulations govern the type of program you are designing?
- Are there particular communities/social or political activists that will react to this plan?
- Will this information become public knowledge?
- How do you anticipate the media will react to this program?

### Stakeholders

- What is the likely perspective of shareholder advocates on this program or issue?
- Will the general employee population perceive this program as fair?

## Situation (continued)

Despite the scandal and ongoing investigation at the time of his departure, the

terms of the CEO's employment agreement provided him with the ability to collect as much as \$175 million in severance, pension and stock.

### **External Environment**

- To what extent do you want to match or differ from market pay practices?
- Will this information become public knowledge?
- How do you anticipate the media will react to this program?

### **Stakeholders**

- Are committee members familiar with similar programs or issues?
- Has the committee consultant been briefed about the proposed program or issue?
- Has the committee been adequately prepared to discuss this program or issue in previous meetings?
- Does the committee employ an independent compensation consultant?
- Will the general employee population perceive this program as fair?
- What tools and processes are in place to support compensation committee decision making (e.g., tally sheets)?

### **Disclosure & Transparency**

- What is the company's philosophy regarding transparent disclosure in the proxy statement (e.g., minimally compliant versus full disclosure and effective communications)?

## **Situation (continued)**

Because of the backdated options scandal, the company adopted a new policy that all stock option grants and the terms of the grants be approved by the compensation committee. The company also a nonexecutive chairman of the board, a chief compliance officer, and did not grant any stock options to executives in 2006.

### **Internal Environment**

- Has your accounting division reviewed this program design from an accounting treatment perspective?
- Is the legal department comfortable with this design in the current legal/regulatory environment?

### **External Environment**

- To what extent do you want to match or differ from market pay practices?

### **Stakeholders**

- What is the likely perspective of shareholder advocates on this program or issue?
- How and when will you disclose this plan to shareholders?
- Has the compensation committee/board of directors reviewed similar compensation programs or issues in the past?
- Are compensation committee members/board of director members familiar with similar programs or issues?

### **Disclosure & Transparency**

- What is the company's position on appropriate level of transparency (disclosing more than is required, simplification of written communications)?

Citation: KB Home, 2006, Los Angeles Times, 2006, and KB Home, 2007

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## How Companies Should Balance Growth & Financial Returns in

# Executive Incentive Plans

Part One

By Michael Marino and Ira Kay, Watson Wyatt Worldwide

Increasing shareholder value is the primary objective of the corporation. However, creating continuous improvements in shareholder value is an elusive goal for many executive teams. Because companies typically get what they measure, it is important that they measure the right thing.

Many companies do a high-level, cursory review of executive-incentives metrics. However, few undergo a systematic exercise to evaluate the link between performance-incentive plan focus and increased firm value. As a result, some incentive plans are simply outdated and accidentally focus executives on past goals and objectives. In other cases, corporations unwittingly employ metrics that they believe are designed to create shareholder wealth, but which fail to achieve this goal. Therefore, companies can create enormous shareholder value by improving the line of sight regarding financial objectives in executive-compensation programs.

While there is no guarantee that excellent future financial performance will prompt stock prices to rise, a robust methodology for choosing the best metrics is essential to corporate success, positive shareholder relations and good governance. As the following example of a “typical industrial company” shows, it is possible to find a method that balances financial objectives in executive-incentive design.

### QUICK LOOK

- ➔ The current scrutiny of executive pay makes performance measurement essential to the proper determination of whether “pay for performance” exists.
- ➔ There are three cornerstones to building a robust framework: review corporate strategy, identify value drivers and review market expectations.
- ➔ The more that boards and institutional investors require a clear pay-for-performance link, the more imperative it is that executive-incentive design supports shareholder value.

### Why is Financial Focus So Important? Why Now?

The current scrutiny of executive pay makes performance measurement essential to the proper determination of if “pay for performance” exists. Performance metrics are important at the executive level for



many reasons. First, they serve as a means for the board to signal the company's strategic imperatives to executives and shareholders. Second, metrics provide a direct link between corporate strategy and compensation. When the right metrics are incorporated in annual and long-term incentive plans they align executives with shareholders, focus executives on increasing shareholder value and provide a consistent framework for rewarding behavior.

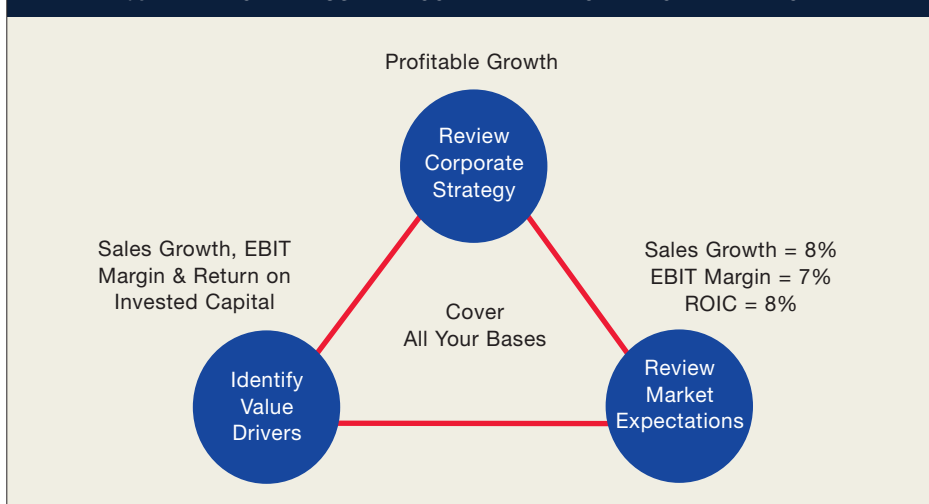
Satisfying these objectives is paramount because public concern about executive pay has never been greater. Recent Watson Wyatt research found that boards of directors and institutional investors have defined views about executive pay. Sixty percent of board members surveyed believe the executive-pay models at most companies have dramatically overpaid executives, while 90 percent of large pension funds expressed the same concern. However, when asked if the executive-pay model in the United States has improved corporate performance, the two groups are split. Sixty-five percent of boards believe the executive-pay model has improved corporate performance, while only 21 percent of pension funds share that view.

Therefore, the current scrutiny of executive pay makes performance measurement essential to the proper determination of whether "pay for performance" exists.

### Step 1: Develop a Performance Framework

Companies that consider where to focus line of sight and that gauge market expectations make more well-informed decisions. The process for calibrating financial focus begins with establishing a performance framework that provides insight into key strategic themes, value drivers and market expectations for future performance.

FIGURE 1: TYPICAL INDUSTRIAL COMPANY PERFORMANCE FRAMEWORK



This framework is formed by reviewing readily available internal and external information sources. There are three cornerstones to building a robust framework.

1. Review corporate strategy.
2. Identify value drivers.
3. Review market expectations.

Figure 1 presents a completed performance framework for our hypothetical company.

The baseline includes the key strategic themes, value drivers and market expectations. At this company, the baseline shows that:

- Profitable growth requires a focus on growth and financial returns.
- Sales growth, operating profit and return on invested capital are key value drivers.
- The market is expecting an 8-percent annual sales growth, a 7-percent earnings before interest and taxes (EBIT) margin and an 8-percent return on invested capital (ROIC).

### Step 2: Create a Growth and Returns Matrix

Companies increase value when they earn high returns on incremental invested capital. A simple two-by-two financial model helps illustrate how growth and returns support value

creation. Let's assume our "typical industrial company" has \$500 in sales, \$1,000 in capital and a 10-percent cost of capital. Furthermore, let's assume sales grow of either 5 percent or 15 percent next year (the vertical axis) and that capital grows in proportion to sales. Therefore, capital will grow from \$1,000 to \$1,050 or \$1,150, respectively. Assuming actual ROIC of either 5 percent or 15 percent (the horizontal axis), it is possible to calculate the nominal (gross) value improvement. Value improvement will range from \$2.50 to \$22.50. Under these conditions, all combinations of growth and returns generate nominal value improvement. However, this is not the complete story and may incorrectly suggest that growth is always good. This analysis does not address the cost of capital employed and whether gross returns exceed costs. Taking the nominal value and subtracting a charge for the cost of capital (for these purposes, 10 percent) creates a better picture of value creation because all capital has a cost—nothing is free. Figure 2 on page 29 presents a modified matrix that reflects nominal and economic value given different combinations of growth and returns.

For the "typical manufacturing company," growing sales under certain

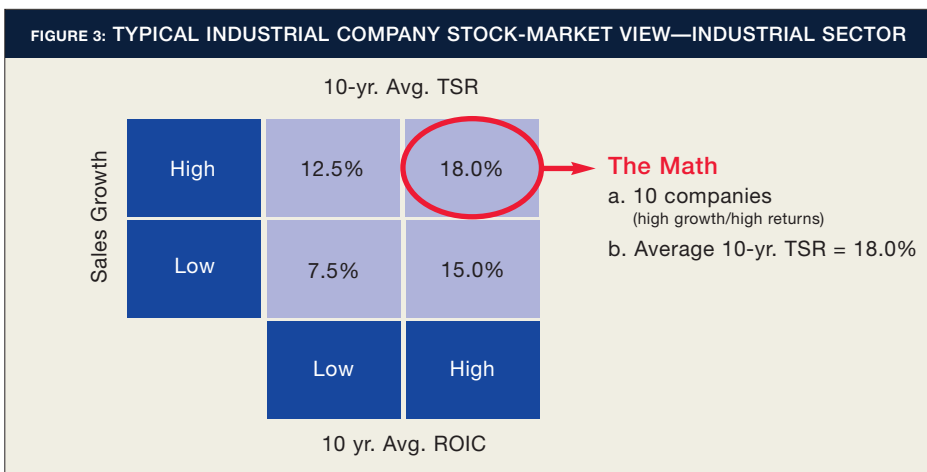
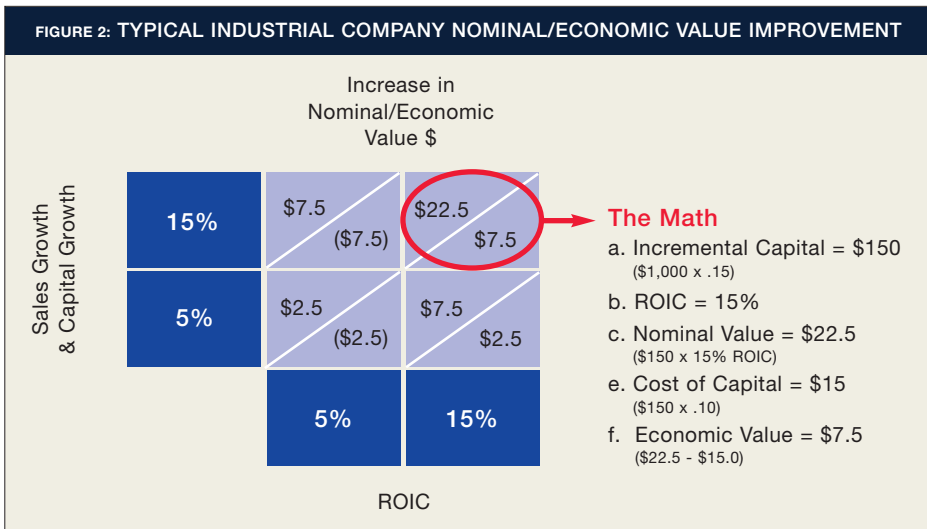
conditions will increase value. Specifically, when the business generates returns in excess of costs, growth adds to the value of the enterprise. Growing sales without commensurate high levels of return will destroy value. In this case, the company that grew sales and capital by 15 percent but earned only a 5-percent return on capital (the upper left hand quadrant) actually destroyed value. In essence, the company earned \$7.50 gross at a cost of \$15 yielding (\$7.50).

### Step 3: Read the Stock Market


The last step to understanding the relationship between growth in revenue and financial returns is to read the public market. To accomplish this, the same two-by-two growth and return matrix is utilized for a peer group. However, this requires calculating the median sales growth and median ROIC over a 10-year period and placing each company, based on above- or below-median performance, in one of four unique quadrants. Next, calculate the average total shareholder return (TSR) for the companies in each quadrant. Figure 3 shows the impact of growing sales and/or increasing returns.

### Bringing it all Together

Applying this approach to our “typical industrial company” provides a fresh perspective. First, the company is pursuing a profitable growth strategy, and the market expects certain levels of performance. Second, the growth-and-returns matrix shows that, given this specific fact pattern, growth destroys economic value. Lastly, the market analysis shows that, on average, companies that provide low growth and low returns offer the least shareholder returns. Therefore, line of sight needs to be placed firmly on profitability until returns reach and/or exceed the cost of capital. The recipe calls for more returns and less growth.



### Conclusion

Increasing shareholder value is the objective of the corporation. The more that boards and institutional investors require a clear pay-for-performance link, the more imperative it is that executive-incentive design supports shareholder value. Applying a systematic approach helps companies make informed decisions about financial focus in executive-incentive design. Correct line of sight through executive incentive design is key to establishing pay for performance. Part two of this series, “How Do Market Expectations Influence Shareholder Value and Executive Incentives?”, in the July issue of *workspan*, will address the challenges inherent in measuring shareholder value for public corporations. 

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**Part Two:  
 Shareholder Expectations**

**How Companies Should Balance  
 Growth & Financial Returns in**

**Executive  
 Incentive Plans**

By Michael Marino and Ira Kay, Watson Wyatt Worldwide

The first article of this two-part series focused on the need to choose the right financial metrics and to balance the sometimes competing goals of growth and financial returns when setting executive incentives. While addressing these issues will certainly put employers on the right path to create effective pay-for-performance programs, it is important for employers to also go the next step. This involves considering the role that market expectations play in executive incentive design.

The majority of executive compensation and executive net worth is denominated in company common stock. Executives are typically rewarded with equity grants and in many cases are required to meet specific ownership levels during their executive tenures. Modern corporate finance theory explains that current stock prices reflect expectations of future financial performance. The value of common stock today is highly sensitive to investor expectations for the future. Therefore, the overall net worth of executives will grow or shrink dramatically based on future expectations for financial performance. The challenges inherent in measuring the effects of such expectations are a key part of implementing an effective executive incentive program.

**QUICK LOOK**

- ➔ The overall net worth of executives will grow or shrink dramatically based on future expectations for financial performance.
- ➔ Research has shown that stock prices react to new information in various ways at the time the information is introduced into the market.
- ➔ The value of any common stock is highly sensitive to investor expectations.

**Understanding the Expectations Framework  
 from a Short-Term Perspective**

Companies that use stock price or other market-based metrics must consider the role expectations play in influencing market prices. Research has shown that stock prices react to new information in various ways at the time the information is introduced into the market.



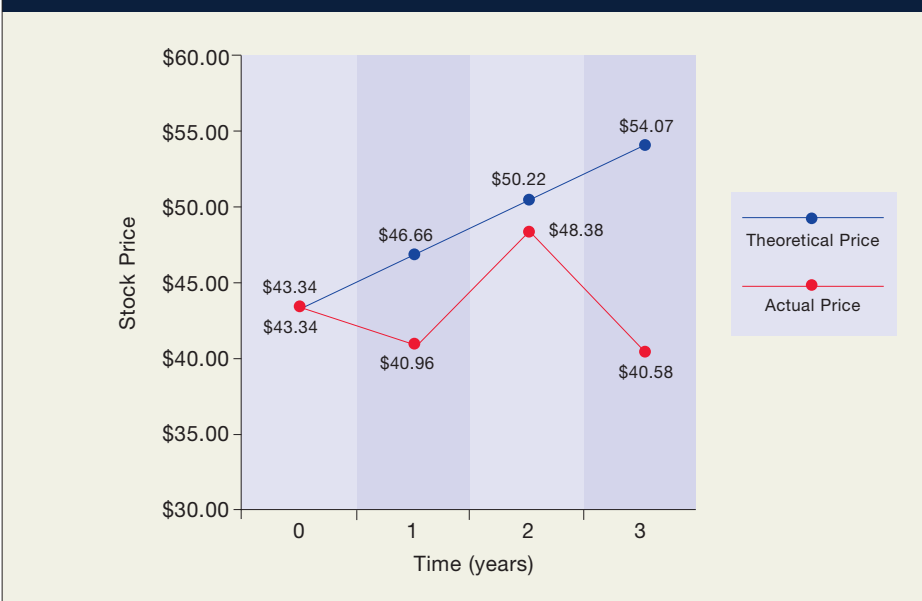
First, missing expectations due to the company's economic performance punishes the stock price to varying degrees based on the level of expectations. Second, exceeding expectations due to fundamental economic performance is rewarded in varying degrees based on the level of expectations. Finally, meeting expectations due to current performance, even if that performance is quite high, is not rewarded because the stock price already reflects those expectations for performance. This is called the "Patrick Ewing" effect. When the New York Knicks acquired Ewing, ticket sales skyrocketed in anticipation of his future performance. When he performed well, sales were sustained. When he performed poorly, sales declined. Therefore, using market-based metrics, such as total return to shareholders (TRS) or stock price, to measure executive performance is challenging because stock prices are highly sensitive to short-term investor expectations.

### Understanding the Expectations Framework from the Long-Term Perspective

The price for any individual stock and its true economic value are not always in equilibrium, even in capital markets that function well. Price and value divergence is demonstrated dramatically when a major market correction occurs, but this dichotomy can also exist at the individual company level under normal market conditions. To test the role of expectations, we compared actual stock price performance to theoretical stock price performance during a three-year period. Theoretical stock price is the expected stock price assuming the stock price grows at the company's cost of equity. Figure 1 plots the results for a large consumer staples company with a cost of equity of 8 percent.

At the end of the performance period, the stock price should have been

FIGURE 1: STOCK PRICE AND VALUE DIVERGENCE, THEORETICAL PRICE VS. ACTUAL PRICE



approximately \$54 assuming the market price tracked with expected returns. The actual stock price was \$40.58. How can this be? The market value of a company's shares depends on how realistic the starting valuation was, and on how well the company performs relative to expectations. If the company had a realistic starting point and it met expectations continuously over the performance period, the two lines would overlap. The issue of individual stock prices and value not moving in equilibrium has serious implications for governing executive compensation programs.

### Issues with Market-Based Metrics

Recent Watson Wyatt's "Finding the Right Balance" found that many institutional investors believe that TRS (defined as stock price appreciation plus dividend yield) is the best benchmark to evaluate executive performance. However, many academics and professionals have cautioned against using this metric when measuring executive performance for the following reasons:

- Stock prices reflect the expectations for future financial performance.
- Expectations are not directly under the control of the executives.

- Subsequent TRS does not account for embedded performance expectations at the start of the measurement period.

It follows that exaggerated expectations at the start of the performance period can influence the likelihood a company will outperform or underperform a peer group. This impacts executives, both positively and negatively, and, therefore, needs to be factored into the metric selection and target-setting process. Several recent CEO terminations manifested this issue. In two high-profile instances, revenues and profits doubled during the CEO's tenure, but stock price declined due to massive reductions in the business valuations. Unrealistic expectations appear to have played a large role in these situations.

### Implications for Incentive Design

Applying a simple framework helps companies understand when market-based metrics are good metrics for executive incentive plans. Figure 2 presents a model that considers start-of-period valuation and stock returns over a typical three-year performance period. The model incorporates Tobin's Q as a gauge of enterprise value at the start of the performance period. Tobin's Q measures a company's

FIGURE 2: VALUATION AND RETURNS MODEL  
THEORETICAL CONSTRUCT

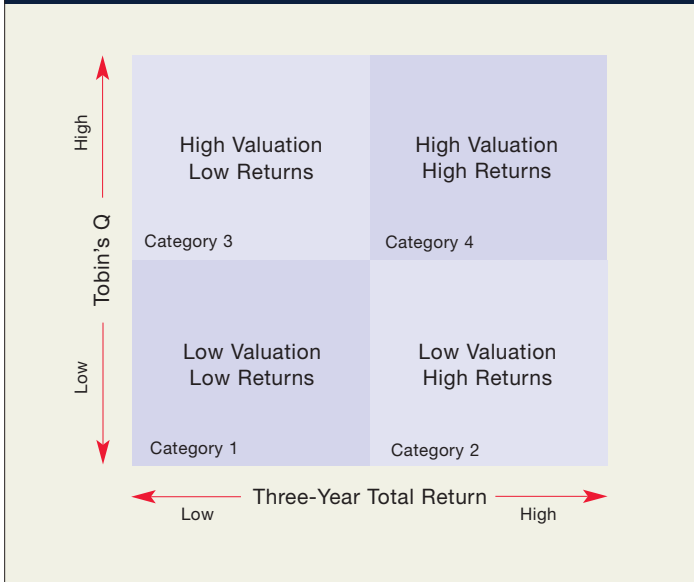
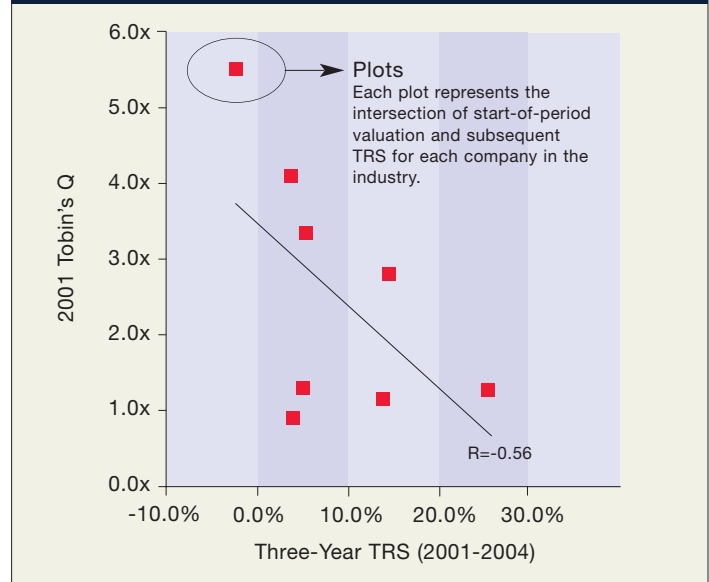


FIGURE 3: VALUATION AND RETURNS MODEL  
S&P 500 BEVERAGE INDUSTRY



value as a multiple of the replacement cost of its existing assets. It is an economic price-to-book valuation multiple that includes market expectations. Companies with a high Tobin's Q have relatively higher embedded expectations than those with a low Tobin's Q.


Categories 1 and 4 have consistent outcomes (low/low or high/high). Highly valued companies deliver superior shareholder returns, and lower-valued companies deliver lower shareholder returns. This is possible over the long term. However, this is less likely over shorter periods of time, for reasons cited earlier in this report. Essentially, economic theory would predict that, on the average, highly valued companies would underperform on TRS as investor capital migrates to companies with greater opportunity. Categories 2 and 3 are the mixed outcomes. Highly valued companies do not all deliver high returns, and lower-valued companies can deliver high returns. Figure 3 provides an ex post facto analysis for a specific industry to illustrate the relationship between valuation and returns.

For this industry, there is a negative correlation between start-of-period Tobin's Q and three-year TRS. This

analysis shows that it would not be fair to hold executives responsible for delivering median TRS when they are valued above the median Tobin's Q at the start of the period. In addition, relative performance vesting may not properly compensate the executives at an already highly valued company because it would require companies to achieve two goals: (1) median TRS and (2) sustained valuation premium over the peers. Conversely, delivering median TRS at a low-Q company might be too easy. Research has shown that there is often a negative correlation between starting company valuation and TRS over a typical three-year performance period.

### Conclusion

The value of any common stock is highly sensitive to investor expectations. Using market-based metrics to measure executive performance is challenging since stock prices are highly sensitive to investor expectations. Recognizing the challenges of using market-based metrics from both the short-term and long-term perspectives is the first step toward using market metrics most effectively in executive incentive design. Creating a valuation-

and-returns model helps companies decide if using a market-based metric makes sense for a given situation and helps companies set reasonable goals. 

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# Alignment of Business Strategies, Organization Structures and Reward Programs: A Survey of Policies, Practices and Effectiveness

A Report by WorldatWork

Dow Scott, Ph.D., Loyola University

Tom McMullen, Bill Bowbin  
Hay Group

John Shields, Ph.D., University of Sydney

May 2009

research





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## **Alignment of Business Strategies, Organization Structures and Reward Programs: A Survey of Policies, Practices and Effectiveness**

May 2009

Research for this report was conducted by members of the WorldatWork surveys and research team; Dow Scott, Ph.D., Loyola University Chicago; Tom McMullen and Bill Bowbin, CCP, Hay Group; and John Shields, Ph.D., University of Sydney. The authors would like to thank Richard Sperling, Sperling HR, and Dennis Morajda, Performance Development International LCC for their contributions to the survey initiative.

### **INTRODUCTION**

A competitive business advantage is derived from the alignment of business strategies and reward programs. For compensation professionals, this is practically an axiom, similar to the saying “practice makes perfect” for the musician or the formula “E=MC<sup>2</sup>” for physicists. The WorldatWork Total Rewards Model specifies that the business strategy, organization culture and HR strategy should be the primary determinants of reward strategy and program design to positively impact performance and results. Open any compensation textbook and you will find chapters dedicated to linking business strategy and reward programs. However, this compensation tenet contradicts our search for “best” reward practices, defined as reward programs and policies that are superior to other policies and programs regardless of the organization’s business or HR strategy, how the organization is structured, or other characteristics of the organization.

In a 2007 survey, WorldatWork members identified pay program alignment as one of the most important strengths or areas that *needed* improvement (Scott, McMullen, Sperling and Bowbin, 2007).

While academicians and consultants place great importance on the alignment of reward strategies and programs with business strategy, research on the topic is limited. As a result, the research team from Hay Group, WorldatWork and Loyola University Chicago surveyed a representative sample of WorldatWork members to determine how they formulate and align their business strategies, organization structure and reward programs. Then the team examined the effects of competitive strategy alignment with organizational structure, pay policies and programs relative to three measures of organization performance.

#### **Rewards Alignment Model:**



\*Adapted from Miles & Snow typology.

The specific research questions were:

- How do organizations define the linkage between business strategy, organizational structure and reward strategies and programs?
- What are the specific actions that organizations adopt to align their business strategy, organizational structure and reward strategies?
- How does the alignment of business strategies and reward strategies and programs affect organization performance?

**METHODOLOGY**

**Data Collection and Sample Characteristics**

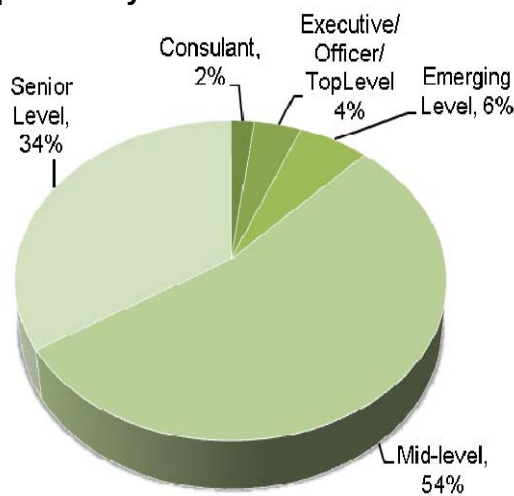
Seven thousand WorldatWork association members were invited to participate in this study, which was open from Jan. 5 through Jan. 20, 2009.

We received 449 valid responses from WorldatWork members. To reduce the potential for statistical error, we dropped multiple responses from the same organization. The responses kept represent the most senior-level participant with the assumption that he/she would be more cognizant of the strategic issues in the organization.

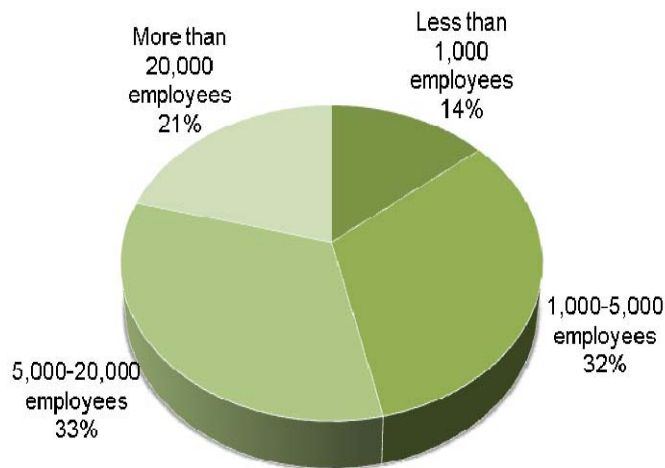
**Respondent Demographics**

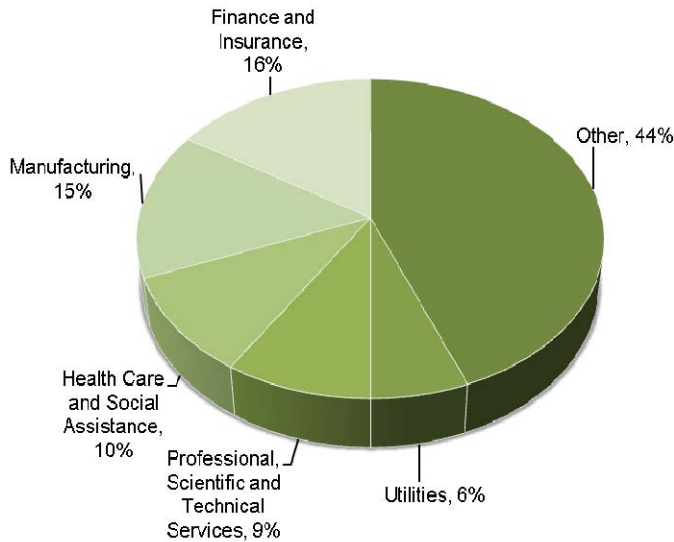
Respondents represented the range of reward/HR professionals and reported data for organizations covering a diverse range of industries and sizes.

**Responsibility Level:**



**Organization Size:**



**Industry:****Study Variables and Measures**

The well known and highly regarded Miles and Snow typology was the basis for developing the competitive strategies measures, categorized as: "defender," "analyzer" and "prospector." Organization structure (degree of centralization) was based on the equally well known Burns and Stalkers typology. The reward strategy, policies and program measures listed in Figure 1 were specifically developed for this study. We adopted and modified items from similar scales or added items of our own based on our knowledge and experience with these variables (e.g., pay variability, pay communications and non-cash rewards). The measures are defined in the next section, "Findings," and individual items that make up these measures are shown in the tables.

Three measures of organizational effectiveness were also assessed. One was a self-assessment of relative organizational performance as rated by survey respondents. "Please indicate how your organization compared to its competitors. Consider how the organization performed, on average, over the past *three* years." Respondents rated their organizations' overall performance compared to competitors as: lowest, 1% to 20% (1%); low, 21% to 40% (7%); middle, 41% to 60% (33%); high, 61% to 80% (32%); and top, 80% to 100% (28%). Even though one might expect a certain amount of upward performance bias, this subjective measure of performance was strongly correlated with the financial measure of total shareholder return (TSR) over a three-year period. TSR is the change in the organization's stock price plus any dividends paid over a three-year period. This measure was only available for companies that were listed on public stock exchanges.

Fortune's Most Admired Company designation was the third rating of organization effectiveness used. Hay Group derives the Most Admired Company rankings for *Fortune* magazine and has first-hand knowledge of what makes the Most Admired Companies great. This rating is awarded by industry experts based on both financial results and qualitative evaluation of company performance. In determining industry rankings, Most Admired Companies are rated on nine key attributes:

Raters are asked to assess each eligible company in their industry on each of the following:

- Ability to attract and retain talented people

- Quality of management
- Quality of products or services
- Innovation
- Long-term investment value
- Financial soundness
- Wise use of corporate assets
- Social responsibility to the community and the environment
- Effectiveness in conducting business globally

A total of 49 companies in the sample were rated as Most Admired Companies, which were compared to 250 non-Most Admired Companies of similar size.

### ***Data Analysis***

Once the data were collected, we confirmed that variables were valid and reliable through factor analysis and alpha coefficients. These analyses can be obtained from the senior author, Dow Scott, Ph.D. To determine the relationship between the variable Pearson correlations, t-tests were used.

## SURVEY FINDINGS

Recognizing that reward alignment occurs at several junctures, the findings are first grouped by:

- Competitive strategy (Miles and Snow typology)
- Organizational structure, degree of decentralization (Burns and Stalker typology)
- Pay structure and competitive position of pay levels
- Performance measurement
- Pay variability
- Pay communication
- Non-cash rewards

Next, we assess the degree to which these factors are aligned and the strength of their relationship to organizational performance. Given the scope and detail of the information collected from WorldatWork members, the text below highlights the more interesting findings and refers the reader to the tables for the specific information collected and how survey participants responded.

### ***Competitive Business Strategies***

The alternative business strategies that an organization might follow to successfully compete have been defined by numerous authors; the models and definitions of these constructs are often similar. We selected the Miles and Snow (1978) typology which defines a straight-forward description of alternative strategies and a typology quite often used by researchers. Miles and Snow identified three market competitive strategies: defenders, analyzers and prospectors.

Shields (2007) provides a brief description of each:

- **Defenders** act to protect and preserve their market share from existing and new competitors. They will have only one core product or service line and focus on improving the technical efficiency of their existing operations. A defender will seek to maximize the efficiency of existing technical methods, hence emphasizing cost minimization or quality enhancement, or a balance of the two.
- **Analyzers** are cautious diversifiers. They may have one or two core products or services and one or more non-core product lines that are spin-offs from the core business. Analyzers are more likely to be market followers than market leaders and will also be inclined to compete on quality rather than cost, at least in the long term.
- **Prospectors** are habitual diversifiers. They are proactive and perhaps aggressive market opportunists and risk takers with a diverse and ever-changing portfolio of products and little loyalty to any particular type of product and service. They are constantly on the lookout for new and more attractive market opportunities, always trying to be first into a new product or service area. The emphasis is on speed, agility, technological dynamism, flexibility and risk taking, particularly to anticipate new customer needs and maintain a competitive advantage....” (See pages 107-108).

Tables 1 through 7 provide data as to how survey respondents describe the competitive strategy or strategies followed by their organizations. Although these organizations did not define the defender strategy consistently as per Miles and Snow, most respondents indicated

that their organizations attempt to control costs and champion quality as a competitive advantage. Specifically, 59% of respondents indicated that they vigorously pursued cost reductions and 63% said they exercised tight control of overhead costs. An even higher percentage of respondents agreed that their organizations compete on quality (79%), vigorously pursue improvement in product and service quality (87%), and see product or service quality as more important than price in maintaining market share (59%). The importance respondents place on quality is evident because this scale has the highest average mean score of all the competitive advantage and other pay measures. We suspect this focus on cost and quality reflects the expressed need for continuous quality improvement and cost reduction to survive in the global market. (See Tables 2 and 3).

Far fewer organizations indicate that they consistently follow Miles and Snow's Analyzer strategy as shown in Table 4. Only 11% of organizations agreed that they "preferred to wait" for competitors to introduce new products or services in order to learn from their experiences. However, 46% of the respondents suggest that their organizations carefully monitor the practices of major competitors before adopting those which appear to be the most promising. Most respondents indicated that their organization prefers to diversify into areas compatible with their existing product or service base (74%). The inability to obtain reasonable factor scores or a coefficient alpha of more than .5 indicates that respondents were not consistent in their responses to these items and as such, one must question the notion that there is an overall analyzer strategy to which organizations represented in this study subscribe. As a result, we did not create a scale (i.e., overall measure) for this competitive strategy for further analysis.

As shown in Table 5, respondents were consistent in their responses to the statement that assesses the degree to which their organizations follow or do not follow a prospector strategy (coefficient alpha = .78). Although not all respondents indicate that their organizations follow a prospector strategy, most agree that innovation is "the key to achieving competitive advantage" (66%); and that they must "constantly seek to locate and exploit new product or service opportunities" (61%).

Table 6 indicates that some organizations do not follow a strategy per se or at least do not consistently follow a strategy. Nine percent agree that their senior managers did not understand the business strategy, 16% agree that the strategy was changed frequently and 24% agree that the business strategy was not consistently executed.

We can now examine each of the scales (i.e., measures created) as to how they relate to each other via a correlation analysis shown in Table 23. Based on the self-reported effectiveness measure, organizations attempting to follow a competitive strategy through cost reduction, quality or prospecting were *more likely* to do the following as compared to organizations that did not follow a consistent strategy:

- Centralize their strategic vision, planning and operations
- Link compensation programs to organization effectiveness
- Use compensation programs to reinforce organization culture
- Have accurate performance measurement systems
- Have variable pay
- Use non-cash rewards
- Align their business strategy with their compensation programs.

Based on the TSR effectiveness measure, organizations following a cost-reduction strategy had a negative relationship with organization effectiveness but organizations following the

prospector strategy had a positive relationship with performance. Most Admired Companies were more likely to follow a prospector strategy and more likely to have a strategy than a non-Most Admired Company.

Given that organizations often compete in a variety of industries, leadership must decide to align competitive strategy and centralize operations regardless of the markets or differentiate their strategies and decentralize operations. Table 7 indicates the majority of respondents attempt to “align business units and subsidiaries around a common strategic business vision” and to a lesser degree, centralize operations to achieve cost advantages.

### **Organization Structure (Degree of Centralization)**

Burns and Stalker (1961) theorized that decision making is a predominate driver of organization structure centralized where consistent decisions are made by senior management or decentralized with employees at all levels in the organization having considerable influence on decisions.

Although Burns and Stalker’s scale has been widely used for research, we were unable to discern with factor analysis or alpha coefficient that indeed respondents do assess their organizations as Burns and Stalker believed. As a result, these items in total are neither presented nor analyzed as a scale as shown in Table 8. Although most respondents indicated that their organizations are team based (57%) and encourage employees to take responsibility (85%), only a few indicated a highly decentralized decision-making process (30%) or that employees had considerable input into decisions that affect them (25%). Furthermore, 64% of respondents indicated that communication is “top down”; only 34% *disagreed* that employees receive close supervision, and 54% felt information is shared only with those who need to know. These findings might be viewed as troubling since many organizations purport to be team-based, encourage responsibility and participation. If these responses are indicative of U.S. organizations — few consistently live up to their espoused ideals.

However, the alpha coefficient and factor analysis of Burns and Stalker’s scale indicate our justification for examining two subscales. (See Table 9). These items specifically focus on the extent to which the organization is team-based or sustains centralized policies.

The correlation analysis in Table 23 indicates that team-based organizations are more likely to:

- Link compensation programs to organization effectiveness
- Use compensation programs to reinforce their organization culture
- Use accurate performance measures
- Have higher variability in their pay levels
- Use non-financial rewards more frequently
- Have strategic consistency across business units
- Align their business, HR and compensation strategy
- Consider their organizations more effective than their peers.

The correlation analysis in Table 23 indicates that centralized organizations are more likely to:

- Utilize strategies of cost and quality defenders and prospectors
- Have a team-based organization structure
- Have performance measurement accuracy
- Offer higher variability in their pay levels
- Have better pay communication



- Use non-financial rewards more often
- Use compensation programs that reinforce organization culture and effectiveness
- Have strategic consistency across business units
- Have stronger alignment of their business, HR and compensation strategy
- Have higher self-rated levels of organization effectiveness.

Finally, team-based organization structure was positively related to the three-year average TSR.

### ***Pay Strategies, Policies and Programs***

**Pay structure and competitive position of pay:** Since the statements on pay structure were not designed to represent an overall measure of pay structure, Table 10 provides only descriptive information for each survey statement. Although general consensus exists among compensation professionals about the desirability of having wide pay ranges, few organizations have done so (18%). Most respondents indicate their organizations operate from traditional pay structures (71%) and grant line managers more influence over pay decisions than HR or compensation managers (55% and 34%, respectively).

Most respondents contend that their pay structures target the median for base pay (79%), total cash compensation (58%) and total direct compensation (53%), with organizations slightly more likely to pay above the median as shown in Table 11.

**Performance measurement:** A large percentage of respondents indicate their use of accurate performance measures, i.e., individual employee performance (48%), team or unit performance (41%) and organization performance (75%). The coefficient alpha (.78) indicates respondents purporting to have accurate performance in one dimension, also claim accurate measures for other performance dimensions. (See Table 12). Organizations primarily engage in traditional performance appraisals to measure employee performance (80%); while only 26% suggest that their organizations use multiple measures of employee performance as shown in Table 13.

The reported degree of performance measure accuracy at the individual, team and organizational level was found to be related to self-reported organization effectiveness. Most Admired Companies also report higher levels of performance measurement accuracy than did non-Most Admired Company peers.

**Pay variability:** Managers and compensation professionals have long suggested that substantial pay variability (or differentiation) is a prerequisite to motivate performance, to align company goals or strategies with employee pay, and to attract and retain high performers. However, Table 14 indicates high performers in most organizations do not, in fact, earn substantially more than their peers. Only 19% of the respondents indicated that salary increases for superior performers are at least *two times* the size of increases received by average performers; only 23% agreed that superior performers are paid significantly larger annual salaries (10% or more) than average performers, and only 30% acknowledged a significant variation in annual incentive payouts between superior and average individual performers. It is only with promotions that respondents acknowledge that high performers did substantially better than average performers (83%).

Fifty-seven percent of respondents agreed that employees could earn substantially more if the business unit or the organization performs well. It would appear that more than half the organizations use organization performance measures as a basis for incentive pay.

Few respondents (15%) indicated that their organizations place more pay “at risk” (i.e., variable pay) than do their competitors. Most organizations seem to focus on cash awards (79%) as opposed to equity awards, stock or stock equivalent (8%).

Table 23 reveals that organizations reporting increased pay variability are more likely to operate from a common strategic vision and planning process and centralize operations. Compensation programs are also more likely linked to:

- Organization effectiveness
- Use of compensation programs to reinforce culture
- Report more accurate measures of performance
- Use of non-financial rewards
- Have a consistent strategy across business units
- Align the business strategy with the team-based organization structure, HR and compensation programs
- Report that their organizations are more effective than those of their peers.

Pay variability was found to be related to the self-reported organization effectiveness and Most Admired Companies report higher levels of performance measurement accuracy than did non-Most Admired Companies as shown in Tables 23 and 24.

**Pay Communication:** In two previous studies of WorldatWork members, we learned that compensation professionals believe pay communication is important, yet organizations are doing too little to help employees understand how they are paid and the value of the pay packages they receive (Scott, Sperling, McMullen and Bowbin, 2008; Scott, McMullen, Sperling and Bowbin, 2007). The current study reinforces these findings per the second lowest mean score (2.8), as shown in Table 15. Only 41% of respondents agree that their employees know the pay ranges for their pay grade or position; 21% know the pay ranges for the grade or positions immediately above their own; 36% say the pay information is openly shared by the organization; and only 33% *disagree* that employees have very limited understanding of why they are paid what they are paid. Pay communications, like pay variability, is an area that compensation professionals contend is important, but they admit that they don't do nearly enough to help employees understand how they are paid and the value of their pay packages.

Although Table 23 indicates that effectively communicating with employees is not associated with competitive strategies or organization performance, communications is positively associated with non-financial reward use and negatively associated with five-year TSR.

**Non-cash rewards:** In recent years, compensation professionals have emphasized that employees think in terms of total rewards, which include base pay, variable or incentive pay, benefits and a long list of non-financial rewards. Employee recognition also has been given considerable attention at conferences and in the literature due to its inexpensive application and because employees place considerable importance upon being recognized for their efforts or contributions. As shown in Table 16, only 34% of respondents agreed they have an effective recognition program. Few organizations (7%) reward employees with time off for good performance, even though employee surveys indicate this is a popular reward. Respondents agree their organizations are providing flexible work schedules (65%), are offering numerous development opportunities (55%), and are attempting to maintain job security for high performing employees (71%).

Use of non-financial rewards is associated with team-based organization structures, following a prospector strategy, pay variability, and organization effectiveness.

**Strategic alignment and compensation programs:** As shown in Table 17, respondents indicate that their compensation programs reinforce financial performance (80%) and customer satisfaction (53%). To a lesser extent, compensation strategy reinforces internal processes (41%) and human capital development (41%).

For the most part, respondents acknowledge their compensation programs are used to reinforce a culture of individual performance (81%) and collaboration and teamwork (58%). To a lesser extent, the compensation programs reinforce a culture of creativity and innovation (39%). (See Table 18).

Thirty-eight percent of the respondents indicate that compensation programs have changed in the last four years, whereas, 51% indicate their programs have not changed. The business strategy (70%), HR strategy and compensation strategy are consistent (70% and 68%, respectively). (See Table 19).

**Alignment of the competitive strategy, organization structure and pay system:** As shown in Table 20, most respondents indicate that their business strategy was aligned with the HR strategy, organization structure and compensation strategy (65%, 70%, and 54%, respectively). It is interesting that few respondents indicated their business strategy was aligned more with compensation strategy than either the organization structure or HR strategy.

Table 21 shows that most respondents perceive their business strategy as effective (57%), and to a lesser extent their HR strategy and their compensation strategy (43% and 40%, respectively).

Alignment of the business strategy and compensation programs was found to be related to the self-reported organization effectiveness, and Most Admired Companies reported higher levels of alignment than did non-Most Admired Companies as shown in Tables 23 and 24.

**Relationship of Strategy, Organization Structure, Pay System and Performance:** In summary, perceived organization effectiveness is positively associated with the survey's variables with the exception of those claiming not to have strategy or number of assessors used.

## CONCLUSIONS AND RECOMMENDATIONS

Unlike most surveys of compensation practices, this research attempts to test a fundamental assumption of the profession: Does alignment of business strategy with compensation strategy, policies and programs increase organizational performance? In short, our research indicates this assumption is in fact true. More specifically, we found higher levels of organization performance when the following occurred:

- Organizations utilized a defined competitive business strategy and they followed a quality defender or prospector strategy.
- The competitive business strategy was aligned with HR and compensation strategies.
- The organization adopted more centralized policies and programs across business units and was team-based.
- There were accurate measures of performance, higher levels of pay variability and use of non-cash rewards.
- There was a consistent business strategy across business units.

This research has certain limitations. First, since most of the variables were collected at one point in time and correlation analysis was used, relationships between variables could *not* determine causality. Second, the organization assessment of business strategy and pay strategy, policies and programs was based on the individual assessment of (typically) a senior compensation person and was not verified by other sources. Finally, TSR was substantially affected by the economic crisis in the United States. However, even with these limitations, the overall findings were consistent with alignment theory and previous research.

As a result, we suggest that organizations take the following action:

- Spend adequate time in aligning their pay strategies, policies and programs with the business strategy
- Create strategies, policies and programs that are consistent across business units
- Emphasize pay strategies, policies and programs that encourage pay variability, performance measure accuracy and non-cash rewards.
- Frequently reinforce their business, performance and reward strategies through the involvement of senior leadership and line management and via a well-crafted rewards communication strategy.

## REFERENCES

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**Table 1**  
**Competitive Strategy - Defender**

	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	
Offers a narrow range of products or services	51	11%	200	45%	40	9%	129	29%	26	6%	2.7
Aggressively protects its existing product or service markets from competitors	11	2%	32	7%	116	26%	207	47%	75	17%	3.7
Prefers to penetrate deeper into its existing markets rather than diversify into new product or service areas	9	2%	115	26%	141	32%	135	31%	36	8%	3.2
Prefers growth to be cautious and incremental	16	4%	132	30%	101	23%	172	39%	22	5%	3.1
Competes chiefly by offering its products or services at the lowest possible prices	54	12%	217	49%	121	28%	40	9%	7	2%	2.4

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.  
 Factor loading and the coefficient alpha score did not justify treating these items as a scale.

**Table 2**  
**Competitive Strategy - Cost Reduction**

	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score	
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %		
Vigorously pursues cost reductions	12	3%	61	14%	107	24%	209	47%	54	12%	3.5	
Exercises tight control of overhead costs	8	2%	68	15%	86	19%	222	50%	59	13%	3.6	
<b>Coefficient Alpha = .69</b>											<b>Average Measure Score</b>	<b>3.6</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

Table 3 Competitive Strategy - Quality Defender											
My organization:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	
Competes chiefly by providing products and services of the highest possible quality	2	0%	17	4%	71	16%	217	49%	133	30%	4.1
Vigorously pursues improvement in product and service quality	1	0%	14	3%	42	10%	258	59%	124	28%	4.1
Sees product or service quality as more important than price in maintaining market share	5	1%	33	8%	139	32%	184	43%	71	16%	3.7
<b>Coefficient Alpha = .75</b>										<b>Average Measure Score</b>	<b>3.9</b>

Due to rounding, the valid percentages may not total 100%; ~~V~~valid percentages do not include missing responses.

Table 4 Competitive Strategy - Analyzer											
My organization:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	
Is seldom first to enter a new or emerging product or service area	32	7%	145	34%	126	29%	112	26%	17	4%	2.9
Carefully monitors the practices of major competitors before adopting those which appear to be the most promising	4	1%	81	19%	149	35%	170	40%	26	6%	3.3
Prefers to wait for competitors to introduce new products or services in order to learn from their experiences	32	7%	206	48%	148	34%	38	9%	8	2%	2.5
Prefers to diversify into areas compatible with its existing product or service base	2	0%	19	4%	89	21%	262	62%	53	12%	3.8

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.  
 Factor loading and the coefficient alpha score did not justify treating these items as a scale.

**Table 5**  
**Competitive Strategy - Prospector**

My organization:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score	
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %		
Offers a wide and constantly changing range of products or services	11	3%	148	34%	126	29%	119	28%	28	6%	3.0	
Uses a wide and constantly changing range of technologies	11	3%	107	25%	91	21%	192	44%	34	8%	3.3	
Constantly seeks to locate and exploit new product or service market opportunities	4	1%	51	12%	112	26%	228	52%	40	9%	3.6	
Responds rapidly to emerging market opportunities	8	2%	88	20%	168	39%	140	32%	27	6%	3.2	
Sees innovation as the key to achieving competitive advantage	5	1%	53	12%	89	20%	196	45%	92	21%	3.7	
<b>Coefficient Alpha = .78</b>										<b>Average Measure Score</b>		<b>3.4</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

**Table 6**  
**Competitive Strategy – None or Inconsistent**

In my organization:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score	
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %		
Senior managers do <u>not</u> understand the business strategy	124	28	229	52	44	10	34	8	6	1	2.0	
Business strategy changes frequently	34	8	228	52	106	24	64	14	10	2	2.5	
Business strategy is <u>not</u> consistently executed	36	8	206	47	92	21	93	21	12	3	2.6	
* Seldom makes changes in products or services offered unless forced by the market	38	9	238	55	99	23	51	12	3	1	2.4	
<b>Coefficient Alpha = .75</b>										<b>Average Measure Score</b>		<b>2.4</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.



**Table 7**  
**Organization Centralization – Vision, Planning and Operations**

My organization:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	
Effectively integrates operations to exploit economies of scale	9	2%	76	18%	168	39%	161	37%	18	4%	3.2
Has common business planning processes across all operations	16	4%	108	25%	92	21%	184	42%	33	8%	3.3
Aligns business units or subsidiaries around a common strategic business vision	10	2%	51	12%	70	16%	250	58%	51	12%	3.7
Achieves cost and scale advantages through centralized operations	13	3%	70	16%	124	29%	195	45%	29	7%	3.4
<b>Coefficient Alpha = .75</b>										<b>Average Measure Score</b>	<b>3.4</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

**Table 8**  
**Organization Structure - Centralization and Participation**

In my organization:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	
Employees receive close supervision	11	3%	136	31%	154	35%	128	29%	10	2%	3.0
Following rules, guidelines and procedures is less important than getting results	43	10%	189	43%	90	20%	108	24%	14	3%	2.7
Work in our organization is highly team-based	3	1%	77	17%	113	25%	200	45%	53	12%	3.5
Decision-making processes are highly decentralized	37	8%	181	41%	90	20%	111	25%	22	5%	2.8
Communication is from the top down	5	1%	59	13%	93	21%	229	51%	60	13%	3.6
Employees have considerable input into decisions that affect them	20	5%	175	40%	137	31%	103	23%	8	2%	2.8
There are consistent job designs and organization structures across the organization	32	7%	131	29%	53	12%	194	44%	35	8%	3.2
Job duties are clearly defined	15	3%	74	17%	78	18%	252	57%	25	6%	3.4
Information is shared with only those who need to know	8	2%	103	23%	95	21%	202	46%	35	8%	3.3
Employees are encouraged to take responsibility	1	0%	19	4%	47	11%	273	61%	107	24%	4.0

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.  
 Factor loading and the coefficient alpha score did not justify treating these items as a scale.

**Table 9  
 Organization Structure – Team Based**

In my organization:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score	
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %		
Work in our organization is highly team-based	3	1%	77	17%	113	25%	200	45%	53	12%	3.5	
Decision-making processes are highly decentralized	37	8%	181	41%	90	20%	111	25%	22	5%	2.8	
Employees have considerable input into decisions that affect them	20	5%	175	40%	137	31%	103	23%	8	2%	2.8	
Employees are encouraged to take responsibility	1	0%	19	4%	47	11%	273	61%	107	24%	4.0	
<b>Coefficient Alpha = .56</b>										<b>Average Measure Score</b>		<b>3.3</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

**Table 10  
 Pay Structure**

	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	
Pay ranges are very wide. Maximums are more than 90% higher than minimums	93	21%	220	50%	47	11%	61	14%	16	4%	2.3
Our organization has a traditional pay structure with grades and ranges	46	10%	58	13%	21	5%	234	53%	81	18%	3.6
Internal company values (e.g., job evaluation) are primarily used to determine job value	42	10%	159	36%	73	17%	137	31%	31	7%	2.9
External values (e.g., pay surveys) are primarily used to determine job value or pay	8	2%	37	8%	48	11%	247	56%	105	24%	3.9
Line managers have primary influence over pay decisions	9	2%	106	24%	82	18%	215	48%	33	7%	3.4
Human resources or the compensation department has primary influence over pay decisions	18	4%	169	38%	110	25%	127	29%	20	5%	2.9

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.  
 Diverse set of pay practices is not intended to form a scale.

**Table 11**  
**Competitive Position of Pay**

	Below Median (1)		At Median (2)		Above Median (3)		Don't Know/ Not Available	Mean Score
	#	Valid %	#	Valid %	#	Valid %		
Base salary structures	45	10%	343	79%	44	10%	15	2.0
Total annual cash compensation (base pay plus target short-term incentives)	62	15%	233	58%	107	27%	43	2.1
Total direct compensation structures (base cash plus target short- and long-term incentives)	67	18%	195	53%	108	29%	71	2.1

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

**Table 12**  
**Performance Measurement - Accuracy**

	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score	
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %		
Individual employee performance is accurately measured	17	4%	94	21%	120	27%	189	43%	24	5%	3.2	
Team, department or unit performance is accurately measured	17	4%	112	25%	131	30%	165	37%	16	4%	3.1	
Organization performance is accurately measured	9	2%	39	9%	65	15%	261	59%	70	16%	3.8	
<b>Coefficient Alpha = .78</b>										<b>Average Measure Score</b>		<b>3.4</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

Table 13 Performance Measurement - Number of Assessors											
	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	
Employee performance is measured from multiple perspectives, which may include customers, subordinates and peers (Reversed item)	41	9%	202	45%	86	19%	104	23%	13	3%	3.3
Employee performance is primarily measured by traditional performance appraisal completed only by his/her supervisor-/manager	12	3%	44	10%	36	8%	284	64%	71	16%	3.8

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

**Table 14  
Pay Variability**

In my organization:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score	
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %		
Base salary increase percentages for superior performers are at least <u>two times</u> the size of increases received by average performers	57	13%	227	52%	70	16%	72	16%	14	3%	2.5	
Superior performers are paid significantly larger annual salaries than are average performers (at least 10% more)	40	9%	198	45%	101	23%	88	20%	13	3%	2.6	
There is <u>significant variation</u> in annual incentive payouts between superior and average individual performers	52	12%	173	40%	81	19%	105	24%	26	6%	2.7	
High performers are much more likely to be promoted than average performers	5	1%	30	7%	40	9%	291	66%	75	17%	3.9	
Employees can earn significantly more if the business unit or the organization performs well	21	5%	84	19%	78	18%	184	42%	67	15%	3.4	
Employees can earn significantly more if their team, work unit / department or the organization performs well	34	8%	147	34%	116	27%	112	26%	22	5%	2.9	
Our organization puts more pay “at risk” (i.e., variable pay) than our main competitors	54	12%	194	44%	128	29%	53	12%	11	3%	2.5	
*Incentive pay focuses primarily on cash awards	11	3%	25	6%	56	13%	262	61%	79	18%	3.9	
*Incentive pay focuses primarily on equity awards, stock or a stock equivalent *	126	30%	176	42%	86	20%	31	7%	4	1%	2.1	
<b>Coefficient Alpha = .77</b>										<b>Average Measure Score</b>		<b>2.9</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

\* Item was not included in this scale.

**Table 15  
 Pay Communication**

	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score	
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %		
Employees know the pay ranges for their pay grade or position	67	15%	117	26%	79	18%	144	33%	36	8%	2.9	
Employees know what the pay ranges are for the grade or the positions immediately above their own	87	20%	179	40%	83	19%	76	17%	17	4%	2.5	
Compensation program information is shared openly by the organization	55	12%	154	35%	77	17%	130	29%	30	7%	2.8	
Employees have <u>very limited</u> understanding of why they are paid what they are paid (Reversed Item)	17	4%	128	29%	105	24%	160	36%	36	8%	2.8	
<b>Coefficient Alpha = .83</b>										<b>Average Measure Score</b>		<b>2.8</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.



<b>Table 16 Non-cash Rewards</b>												
	<b>Strongly Disagree (1)</b>		<b>Disagree (2)</b>		<b>Neither Agree nor Disagree (3)</b>		<b>Agree (4)</b>		<b>Strongly Agree (5)</b>		<b>Mean Score</b>	
	<b>#</b>	<b>Valid %</b>	<b>#</b>	<b>Valid %</b>	<b>#</b>	<b>Valid %</b>	<b>#</b>	<b>Valid %</b>	<b>#</b>	<b>Valid %</b>		
My organization has effective non-monetary programs for recognizing employee performance	27	6%	159	36%	109	24%	125	28%	25	6%	2.9	
My organization provides numerous development opportunities for employees	13	3%	83	19%	103	23%	215	48%	32	7%	3.4	
My organization rewards employees with time off for good performance	118	27%	250	56%	48	11%	25	6%	4	1%	2.0	
My organization gives employees special perks and amenities for good performance such as special parking spots, club membership and dinners out	120	27%	237	53%	36	8%	50	11%	2	0%	2.0	
There are often group celebrations for attaining performance goals or for special events	39	9%	129	29%	91	21%	163	37%	21	5%	3.0	
My organization has flexible work schedules to accommodate employee needs	21	5%	64	14%	71	16%	227	51%	62	14%	3.6	
My organization strongly attempts to maintain job security for high performing employees	9	2%	39	9%	79	18%	237	53%	81	18%	3.8	
<b>Coefficient Alpha = .66</b>										<b>Average Measure Score</b>		<b>2.9</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

Table 17 Compensation Programs Reinforce Organization Effectiveness											
The compensation programs reinforce the importance of the:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	
Organization's financial performance	10	2%	37	8%	40	9%	236	53%	120	27%	3.9
Customer satisfaction	12	3%	97	22%	97	22%	199	45%	36	8%	3.3
Internal processes	14	3%	119	27%	127	29%	170	38%	12	3%	3.1
Human capital development (i.e., employee development)	20	5%	123	28%	120	27%	162	37%	16	4%	3.1
<b>Coefficient Alpha = .65</b>										<b>Average Measure Score</b>	<b>3.4</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

Table 18 Compensation Programs Reinforce Organization Culture											
The compensation programs reinforce a culture of:	Strongly Disagree (1)		Disagree (2)		Neither Agree nor Disagree (3)		Agree (4)		Strongly Agree (5)		Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	
Creativity and innovation	16	4%	112	26%	136	31%	157	36%	15	3%	3.1
Individual performance	9	2%	32	7%	44	10%	272	61%	87	20%	3.9
Collaboration and teamwork	14	3%	60	14%	113	26%	215	49%	39	9%	3.5
<b>Coefficient Alpha = .68</b>										<b>Average Measure Score</b>	<b>3.5</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

Table 19 Consistency of Strategy Across Business Units												
Across business units, my organization's:	Highly Inconsistent (1)		Inconsistent (2)		Neither Consistent nor Inconsistent (3)		Consistent (4)		Highly Consistent (5)		Mean Score	
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %		
Business strategy is	7	2%	48	11%	76	17%	260	59%	48	11%	3.7	
HR strategy is	9	2%	54	12%	67	15%	270	61%	41	9%	3.6	
Compensation strategy is	8	2%	61	14%	72	16%	256	58%	45	10%	3.6	
<b>Coefficient Alpha = .82</b>										<b>Average Measure Score</b>		<b>3.6</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

Table 20 Alignment Business Strategy												
My organization's:	Highly Unaligned (1)		Unaligned (2)		Neither Aligned nor Unaligned (3)		Aligned (4)		Highly Aligned (5)		Mean Score	
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %		
Business strategy and HR strategy are	7	2%	39	9%	107	24%	249	57%	37	8%	3.6	
Business strategy and organization structure are	4	1%	32	7%	99	23%	265	61%	38	9%	3.7	
Business strategy and compensation strategy are	6	1%	61	14%	137	31%	210	48%	26	6%	3.4	
<b>Coefficient Alpha = .86</b>										<b>Average Measure Score</b>		<b>3.6</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

Table 21 Rated Effectiveness of Business, HR and Compensation Strategy												
Please indicate how your organization compared to its competitors, on average, over the past THREE years.	Lowest (1) (1-20%)		Lower (2) (21-40%)		Middle (3) (41-60%)		Next (4) (61-80%)		Top (5) (80-100%)		Not Applicable	Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	
How would you rate the effectiveness of the business strategy?	3	1%	32	9%	126	34%	119	32%	95	25%	47%	3.7
How would you rate the effectiveness of the HR strategy?	9	2%	47	12%	158	42%	120	32%	43	11%	46%	3.4
How would you rate the effectiveness of the compensation strategy?	14	4%	49	13%	166	44%	111	30%	36	10%	47%	3.3
<b>Coefficient Alpha = .83</b>	<b>Average Measure Score</b>											<b>3.5</b>

Due to rounding, the valid percentages may not total 100%; valid percentages do not include missing responses.

Table 22 Organization Effectiveness												
Please indicate how your organization compared to its competitors, on average, over the past THREE years.	Lowest (1) (1-20%)		Lower (2) (21-40%)		Middle (3) (41-60%)		Next (4) (61-80%)		Top (5) (80-100%)		Not Applicable	Mean Score
	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	Valid %	#	
Overall organization performance	4	1%	25	7%	122	33%	118	32%	105	28%	48	3.8

**Table 23**

**Pay Alignment Survey: Scale Correlation Analysis**

	Cost Reduction	Quality Defender	Propsector	None / Inconsistent Strtgy	Org. Cntriztn	Org. Strctre Team Based	Perf. Measure. - Accuracy	Pay Variability	Pay Comm	Non Cash Rewards	Comp Prgms Reinforce Org. Effective.	Comp Prgms Reinforce Org. Culture	Consistency Strategy Across BU	Alignment Business Strategy	Org. Perf. (over 3 years)	Rated Effct Business, HR, Comp Strategy
Quality Defender	.126**															
Propsector	.208**	.342**														
None / Inconsistent Strtgy	-.066	-.336**	-.164**													
Org. Centralization	.361**	.366**	.284**	-.478**												
Org. Structure - Team Based	-.030	.309**	.273**	-.258**	.157**											
Perf. Measurement - Accuracy	.238**	.349**	.247**	-.444**	.511**	.333**										
Pay Variability	.192**	.190**	.234**	-.232**	.330**	.249**	.504**									
Pay Communication	.003	.089	-.016	-.108*	.145**	.025	.114*	-.031								
Non Cash Rewards	.064	.214**	.219**	-.232**	.344**	.352**	.385**	.334**	.228**							
Comp Programs Reinforce Org. Effectiveness	.205**	.343**	.267**	-.352**	.492**	.291**	.476**	.345**	.226**	.363**						
Comp Programs Reinforce Org. Culture	.196**	.379**	.296**	-.387**	.462**	.422**	.550**	.463**	.114*	.379**	.582**					
Consistency of Strategy Across BU	.213**	.320**	.160**	-.493**	.595**	.117*	.446**	.236**	.225**	.307**	.386**	.396**				
Alignment Business Strategy	.250**	.323**	.241**	-.469**	.601**	.201**	.550**	.352**	.214**	.334**	.480**	.510**	.657**			
Org. Perf. (over 3 years)	-.010	.271**	.162**	-.295**	.192**	.179**	.217**	.141**	.038	.125*	.258**	.234**	.184**	.271**		
Rated Effectiveness Business,HR,Comp Strategy	.157**	.320**	.283**	-.439**	.460**	.232**	.450**	.287**	.183**	.303**	.427**	.369**	.475**	.592**	.669**	
3 Year Total Stock Return	-.192*	.080	.199**	-.124	-.066	.199**	-.081	-.003	-.140	.025	.051	.085	-.046	-.038	.308**	.172*
5 Year Total Stock Return	-.172*	.121	.234**	-.091	-.052	.142	-.099	-.011	-.173*	-.058	.069	.084	-.029	-.031	.351**	.186*
	** Correlation is significant at the 0.01 level (2-tailed).															
	* Correlation is significant at the 0.05 level (2-tailed).															

<b>Table 24 Fortune's Most Admired Companies (MAC) Analysis</b>		
<b>Computed Scale</b>	<b>MAC ('07 &amp; '08)</b>	<b>Non-MAC Control Group</b>
Cost Reduction	3.7	3.6
Quality Defender	4.0	4.0
Prospector	3.8	3.4
None or Inconsistent	2.2	2.5
Organization Centralization	3.6	3.3
Organization Structure - Team Based	3.3	3.3
Performance Measurement - Accuracy	3.8	3.3
Pay Variability	3.2	2.9
Pay Communication	2.8	2.7
Non-Cash Rewards	3.2	2.9
Comp Programs Reinforce Org Effectiveness	3.5	3.3
Comp Programs Reinforce Org Culture	3.7	3.4
Consistency of Strategy Across BU	3.8	3.6
Alignment Business Strategy	3.8	3.5
Rated Effectiveness Business, HR, Comp Strategy	3.6	3.4

# a new day for executive compensation

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new SEC disclosure requirements will compel companies to share more information about their executive compensation plans, including the rationale behind plan designs and their link to the business strategy.

Some may view the requirements as intrusive and burdensome. Yet they provide an opportunity to hold a mirror up to the structure and reasoning behind the executive compensation program and articulate how the program helps the business. In these turbulent times, a company needs a firm grasp on that mirror, rather than await the image reflected by the media or institutional shareholder groups.

Unfortunately, too many companies may miss the chance to scrutinize executive pay and shore up its connection to business strategy. When it comes to compensation design, companies often prefer the “known” to the unknown. Change can be threatening, and executive compensation design is complex. Consequently, if the current plan poses no risk to the company, the safe decision is to stick with the status quo, rather than shake things up. When companies decide to make a change, they prematurely may adopt

## QUICK LOOK

- ➔ “One size fits all” has never been the right answer to executive pay. Different business models dictate different approaches.
- ➔ Consider three areas in compensation design: The company’s business situation and market characteristics, talent requirements and desired performance and rewards strategy.
- ➔ As the face of the company evolves, so should the compensation approach.

By Seymour Burchman and  
Blair Jones, Semler Brossy  
Consulting Group



Companies swayed by  
“best practices”  
to adopt the  
plan “du jour”  
and stay under the radar miss  
the opportunity to advance the  
achievement of business goals.

popular plan designs, citing “competitive reasons,” rather than decipher their true needs and construct a plan that acts as a strategic business tool to reinforce desired performance. Consider the following:

- A company relies on a plan that worked in the past, even though the plan is beyond its prime given changes in business strategy and structure.
- A “corporate” plan applies to all business units even though the businesses operate differently and have different strategies.
- Attention focuses solely on long-term incentives (LTI), forgetting long- and short-term plans must harmonize—driving annual operational performance that ultimately will create longer-term financial success.

Companies should take the new SEC disclosure as an opportunity to eschew indistinguishable plan design, overused measures and safe pay-delivery choices. Instead, view the requirements as a chance to reassess the link between compensation design and business strategy, and do what is right for the organization. The feared unknowns will become less intimidating when a company asks the right questions,

considers its business model and uses compensation to advance strategy.

### Ask the Right Questions

What’s the *right* compensation design? A strategic approach to executive compensation considers the following three areas:

1. The company’s business situation and market characteristics
2. Talent requirements
3. Desired performance and rewards strategy.

Answering some pointed questions about each can lay the groundwork for discovering the right direction and building pay and performance alignment. Figure 1 on page 17 identifies many of the questions to ask and explains how the answers will influence plan design. The answers can shape all aspects of program design, from objectives to measures to incentive vehicles.

### Consider the Business Model

“One size fits all” has never been the right answer to executive pay. Different business models dictate different approaches. Companies that overlook or minimize

this link by viewing compensation as a neutral influence at best, or as a distraction at worst, take a dangerously shortsighted outlook. Similarly, companies swayed by “best practices” to adopt the plan “du jour” and stay under the radar miss the opportunity to advance the achievement of business goals.

Take for example companies “X” and “Y.” While they have extremely different business situations, both employ the same compensation approach—time-vested restricted stock. By clinging to easy solutions, these two companies miss the opportunity to use compensation strategically.

Company X, a reasonably mature company in the hospitality industry, follows a strategy of “stay the course.” The strategy is clearly working, as the company has experienced steady stock price growth through recent up and down markets. The company returns value to shareholders through buybacks rather than dividends. Management is stable, with no history or expected risk of executive turnover. Pay prominence is moderate, indicating no need for a behavioral shift. Executive stock ownership guidelines require executives to hold meaningful amounts of stock, thus linking them tightly to business success.

Given this profile, time-vested restricted stock is at best a neutral solution, or, when coupled with significant ownership guidelines, possibly inches toward positive. A *better* approach for a growth company like this is an equity vehicle focused on stock-price appreciation, such as stock options. Time-vested restricted stock does reward retention. But these executives are not intent on leaving. Stock options, on the other hand, spur continual motivation to build on past success. By providing executives the opportunity to share directly in the incremental wealth generated, stock options drive the creation of even more value.



FIGURE 1: CONSIDERATIONS IN DESIGNING EXECUTIVE COMPENSATION

Business and Market Characteristic	Impact on Program Design
1. What are the company's business stage (start up, mature, decline), performance and prospects (industry leader, solid performer, distressed/turnaround)?	Influences the degree of leverage (i.e., how much pay varies with performance) that needs to be built into the program.
2. Are major shifts in strategy ahead?	Determines how specific the messages need to be to guide new behaviors.
3. Is the company and/or its sector volatile and/or cyclical?	Suggests the potential need for indexing or other mechanisms to control for factors beyond management's influence.
4. What is the company's strategy for delivering returns to shareholders (i.e., the relative emphasis on stock price appreciation and dividends)?	Helps to determine the appropriate focus of equity-based vehicles, i.e., stock price appreciation alone, or whether dividends should also be included.
5. What is the organization structure and decision rights (e.g., centralized, single business versus several autonomous business units)?	Helps determine the level of performance measurement, i.e., for the overall company or individual business units, or some combination.

Talent Requirements	Impact on Program Design
<ol style="list-style-type: none"> <li>Does the company need to attract outside talent to replace or support the current leadership team?</li> <li>Does it need to retain existing talent, because either the current executive value proposition is deteriorating, or outside competitors are targeting the company?</li> <li>Does it risk turnover of executives in critical, strategic positions?</li> <li>What degree of behavioral change is needed?</li> </ol>	<p>All influence:</p> <ol style="list-style-type: none"> <li>Types of vehicles chosen, e.g., full-value shares may be more important to include when retention is key or compensation packages from another employer need to be bought out to attract top outside talent; stock options may be more attractive when attracting talent to help with a turnaround or in an entrepreneurial culture.</li> <li>Vesting/performance provisions, e.g., vesting should be longer if the purpose of a vehicle is retention; performance requirements may be structured differently depending on the situation.</li> </ol>

Performance and Rewards Strategy	Impact on Program Design
1. What is the desired role of pay in influencing behavior, especially if material changes in behavior and decision-making are required?	Influences the amount of leverage and performance orientation.
2. What level of alignment is desired between executive and shareholder gains?	Influences the relative weighting of the equity portion of the program and the inclusion of elements that ensure executive net worth at risk (e.g., executive stock ownership or holding requirements).

Time-vested restricted stock alone is a suboptimal answer for Company Y, a diversified manufacturer with a lagging stock price and uncertain future. The company experienced a fundamental strategic shift when it repositioned itself as a services and solution provider. This new direction demands demonstrable growth and some new talent to achieve it. The stakes are high, and the contributions of executives are critical. Performance-vested restricted stock—tied to metrics that reflect the company’s repositioning—plus some stock options provides a better answer. The combination creates the urgency to achieve key milestones and realize the longer-term benefits for the repositioning effort. A small portion of pay (e.g., 20 percent) delivered in time-vested restricted stock could be appropriate to reward executives for sticking with the company during the repositioning while they drive performance forward.

Never assume the old model fits today’s challenges. As the face of the company evolves, so should the compensation approach.

## Using Compensation to Advance Strategy

The following examples show how the right compensation strategy can advance business strategy. In each scenario, the company specifically chose vehicles and metrics to send a message critical to its business and talent needs at the time.

### Same Industry; Different Performance

Companies often look to successful industry competitors for hints on incentive plan design. Yet plans are not interchangeable. As the following examples demonstrate, company strategy and situation, not the competition, should dictate compensation approach.

An established “Grande Dame” retail conglomerate had a historical record of aggressive and profitable growth,

generating significant wealth for shareholders. The company acquired and successfully operated new locations ... for awhile. Then consumers discovered outlets and discounters. The big-store market flattened and then dived. The company suffered mightily from consumer defection—same-store sales soon lagged the competition.

Turning around the company required a high degree of behavioral change. Management style needed to shift from a pattern of strict operational control to one promoting innovation and customer responsiveness. Yet, old habits are hard to break, and the veteran executive team initially resisted the new focus. The reward strategy, which had catered to the needs and desires of individual executives, had long since splintered as company strategy disintegrated and results faltered. So a new rewards strategy was defined to promote unity and drive key company metrics, with an emphasis on profitable same-store sales growth. The company began to combat discounters by stressing superior service and simplified quality merchandise assortments. The annual plan directly and aggressively rewarded same-store sales growth. As a counterbalance, and to motivate profitable growth, LTIs rewarded sustained earnings growth and returns. Stock option grants complemented these metrics by reinforcing the new behavior that contributed to an improved financial outcome.

In a contrasting example, another retailer has enjoyed continual profitable sales (experiencing a brief dip in the late 1990s). The company relies on its hallmark strategy, yet desires a firmer position as an industry leader. Leadership is committed to a more aggressive pursuit of strategy, and turnover is not an issue. The company wants to continue its attractive value proposition, not change behavior. Salaries graze the market median or fall just below,

depending on a job’s strategic importance. Real rewards come from incentives. The annual incentive plan is highly leveraged, paying out superior rewards for earnings and return on capital targets, which are set above industry medians. The executive LTI is also highly leveraged, consisting predominately of stock options, which focus on continued growth in total return to shareholders and relative performance that consistently exceeds peers. Metrics for the next management layer include complementary financial and nonfinancial measures that will drive bottom-line profitability. The two plans work in concert to reinforce the strategy.

As these examples demonstrate, if the goal is to change strategy or improve performance, the annual and LTI metrics must explicitly define the desired outcomes. If the company wants to sustain superior performance, it should set goals high and provide high rewards for meeting them. The department store conglomerate is holding its own against discounters; the upscale retailer continues to step ahead of its competition. The custom compensation plans are not neutral influencers of change, but true drivers of behavior change and performance results.

### Same Company; Different Circumstances Over Time

As the retailers recognized, a shift in strategy should trigger a reassessment of the executive compensation plan. Yet what if the strategy remains viable while other circumstances change? The next example shows that even a successful plan design requires rethinking to keep pace with talent demands and business realities.

A health-care company had a record of dramatic growth until an accounting scandal depressed its stock and reduced morale. A new pay program was in order: one that would meet the needs

Even if a plan appears to be delivering results, it is important to keep an eye on changes in business and talent requirements and the implications they hold for incentive design.

of stakeholders—from disillusioned executives to angry shareholders—and pass muster with regulators. In this time of turmoil, the company had to hold onto key talent to lead the turnaround, restore trust, and rebuild the business and its reputation. To strengthen retention, the company de-emphasized the annual plan and delivered LTI rewards through performance-restricted stock and options. The LTI combined controllable metrics with key shareholder outcomes, leading to a handsome payoff if the turnaround succeeded. Measures for performance-restricted stock included a balanced mix of hard financials with operational and stakeholder metrics geared toward ensuring operational excellence and constituent satisfaction—returning the company to its mission of providing economical quality care.


Once in place, the compensation plan performed as designed. The company rose like a phoenix to deliver improved financials. Flash forward several years: Growth has moderated and the company is now more a value versus growth investment. Competitors are looking over the company’s talented

leaders, intent on luring them away. The company has updated its executive compensation plan to match current circumstances and demands. Today’s focus is on sustained value creation through continuous improvements in productivity, optimized performance in select facilities and a strong bottom line that allows for continued stock price growth but also strong dividend yields for shareholders. A new annual incentive plan drives these results through financial and nonfinancial measures. In the new LTI, options are less prominent now that the turnaround has succeeded. A larger portion of equity comes from performance-vested restricted stock focused on a balance of earnings growth and overall returns. Selected leaders in key strategic roles also receive grants of time-restricted stock.

Even if a plan appears to be delivering results, it is important to keep an eye on changes in business and talent requirements and the implications they hold for incentive design. A reassessment every three years would not be unusual in these fast-moving times.

## Dust Off the Compensation Philosophy

This is a time of opportunity. The SEC disclosure requirements coming on the heels of recent accounting changes under FAS123R create a clear impetus for re-examining executive pay. Companies that missed the earlier opportunity now get a second chance to make sure their incentive plans are designed to make a difference.

The strongest message a company can deliver in its proxy is to show how the executive compensation program deliberately supports the business goals. Making that cause and effect evident speaks volumes to employees and to shareholders. Jump on their bandwagon; do not let this opportunity pass by. 

### EDITOR'S NOTE:

More information about the new day for executive compensation will be published in part two of this article in the February issue of *workspan*.

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## RESOURCES PLUS

For more information related to this article:

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- Type in this key word string on the search line: **Executive compensation design and business strategy.**

Go to [www.worldatwork.org/bookstore](http://www.worldatwork.org/bookstore) for:

- *The Complete Guide to Executive Compensation*
- *Executive Compensation: The Professional's Guide to Current Issues and Practices*
- *Executive Compensation.*

Go to [www.worldatwork.org/certification](http://www.worldatwork.org/certification) for:

- C6: Principles of Executive Rewards
- C6A: Advanced Concepts in Executive Compensation.