■ SPECIAL FOCUS

LINKING COMPENSATION TO BUSINESS STRATEGY

If companies don't link compensation to long-term goals, they may end up rewarding the wrong results.

James E. Nelson

HERB KELLEHER OF SOUTHWEST AIRLINES, ONE OF THE most colorful of modern-day CEOs, also is clearly one of the most underpaid on any study of competitive practice. Yet his airline consistently earns high marks in terms of customer satisfaction, on-time performance, shareholder value, and employee satisfaction. Adding to Southwest's reputation is the recent release of *Fortune* magazine's inaugural list of the 100 Best Companies to Work for in America, ranking Southwest first. Kelleher's personality may be an anomaly in the traditionally staid world of corporate executives, yet his results speak volumes about getting the right linkages or connections to drive business performance.

What Southwest exemplifies is tight alignment between business strategy and everything else, including compensation. And Kelleher's results are even more remarkable given the bare-knuckle economics of the low-cost, short-haul airline transportation industry. The question, then, is, Why is Southwest so successful? And more significantly, is its success replicable by other companies in other industries?

Experience suggests that the success Southwest enjoys is, indeed, replicable. Companies can succeed by clarifying their business vision or strategy; aligning company pay programs with its strategic direction; measuring what's getting done, including ensuring that the right things are getting measured; and communicating often with employees, using every opportunity to link actions to the firm's strategic focus.

Elements of a Successful Plan

Vanguard work by management theorists suggests that there remains considerable progess to be made on development of effective business strategies in large, complex organizations, particularly in those that operate in global or fast-changing markets. As a result, companies may be tempted wait to get the strategy "right" before linking in the compensation program.

But for executive management, different elements of the pay package are intended to accomplish different purposes. It is the job of the base salary, benefits, and to some extent the perquisite package to attract and retain the required talent, but incentives exist to encourage behavior that accomplishes a company's goals.

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This component in particular, then, must be directly linked to business strategy—even though an organization may be only in the process of defining, articulating, or clarifying its picture of what the business should look like in the future. If there is no such link, companies might just as well use competitive practice as the benchmark for determining executive pay.

And even a poorly designed compensation system can appear to be effective if pay happens to be in line with individual expectations and company performance. But if incentive payments and performance numbers send conflicting signals, the problems will quickly become very clear. For instance, if company performance is good but

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incentives are not paid, executives will be resentful. If the reverse happens—incentives are paid but company performance is poor—shareholders and the board will complain.

The tests of a well-designed incentive compensation plan are both how well it links to strategy and how well it functions in all economic times. Executive incentives are one of the most powerful tools to focus management attention on strategic business goals, in part because incentives provide the direction for executive management to act in its own self-interest.

El Segundo, Calif.-based Mattel Inc. is an example of a company that became a market star by redefining its strategic imperatives, selecting good measures for tracking its performance, and linking management compensation to those measures. In the first five years after implementing its new compensation plan, Mattel achieved a 60% increase in sales, boosted positive cash flow to a rate of more than $150 million per year, posted a return on equity of upwards of 30%, and produced outstanding compounded average annual returns in several areas, including net income and operating margins. The point is that if a company can develop a properly aligned incentive plan, management will respond accordingly. Or, as the Mattel chief executive at the time said: "What gets rewarded, gets done."

Measurement and Communication

In annual studies by Hewitt Associates, data consistently show that financial measures, and in turn, accounting numbers, dominate as the drivers of both short- and long-term incentive plans—usually, earnings per share, net income, and return on equity. But there is lively and growing debate over whether companies are putting too much emphasis on accounting-based measurement as the yardstick of corporate success, and, indeed, whether financial numbers alone tell the whole story, or even the *right* story about a company's performance.

No matter who prevails in the "accounting" vs. "value" debate, the intensity of focus on this issue will not diminish given the pressure in the U.S. on levels of executive pay, fuelled by a booming stock market.

Moreover, the gist of the issue is a real one; that is, what do the capital markets pay for over time—real, long-term value improvement or accounting success? Any incentive plan redesign work today must reflect the movement toward real, value-based measurement. (For more information on this subject, see also "The New Math of Performance Management," The *Journal of Business Strategy*, March/April 1992.)

A related issue is whether financial results provide a rich enough picture of achievement of corporate goals. In seminal work originally published as a series of articles in the *Harvard Business Review*, Robert S. Kaplan, and David P. Norton argue in favor of adopting a "balanced scorecard" approach to measurement—getting

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managers to focus on financials, but also other corporate goals such as improvements in business process, customer service, and work force growth and learning.

Other measurement systems have since emerged that essentially seek to blend the hard realities of the numbers with the "softer" considerations—people, culture, critical tasks, and so forth. The underlying intent is to uncover the causes of effective performance, not simply the effects (higher stock price or its equivalent), and reward executives for their contribution to that performance. Here, too, evidence is emerging that so-called "transformational elements" beyond the financial are beginning to be reflected in senior management pay programs. For example, GE recently converted an executive bonus plan based historically on profit and cash flow to one based 40% on effective implementation of a quality program.

Communication is a key factor in the success of all compensation plans. But rather than simply communicate the basic structure of the plan, effective compensation communication constantly links back to the business strategy so that all employees, from the CEO to the entry-level assistant, understand how their contributions fit into the strategy of the corporation.

According to the Hewitt Variable Compensation Measurement Database, of the companies with variable pay plans that communicate to employees, 79% felt that their plans helped to improve business results. Of companies that had plans but did not communicate, only 55% felt that their variable plans were helpful. When taken beyond objectives and linked to business strategy, communication can be a very effective tool to focus and align employees with the overall direction of the company.

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The Challenges

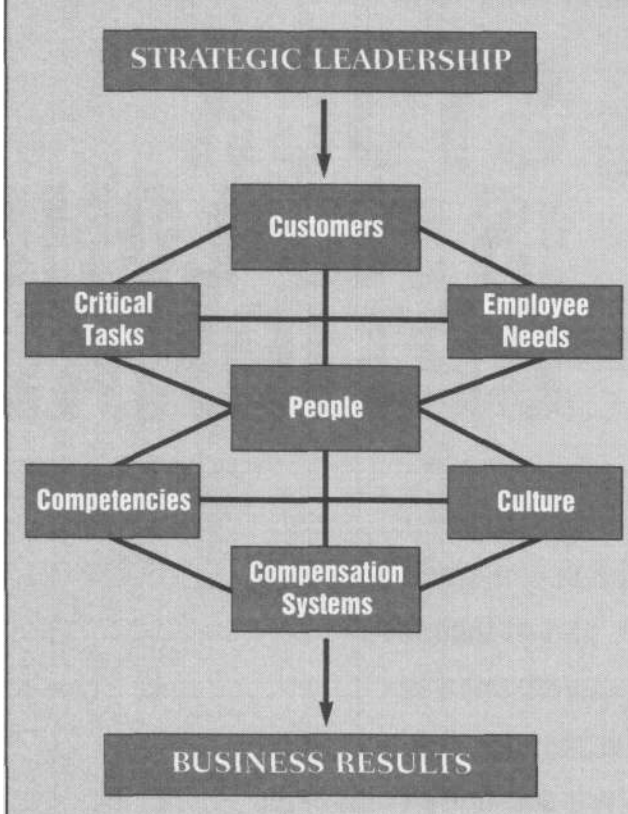
Why is it so tough to get it right? Why are the newspapers littered with accounts of once mighty and powerful organizations brought to their knees, some never to recover? Leading management thinkers and academics point to the conceptual difficulty of balancing and aligning so much at one time.

Some businesses falter because their vision or strategy was inherently flawed, failed to adapt to changing circumstances, or was simply incoherent. Even with a well-defined strategy, there may be difficulties in maintaining the alignment between strategy and compensation. When the company is doing well, executives begin to believe they are "entitled" to certain levels of compensation or a certain perquisite package. What began as a strong philosophy of "pay-at-risk" gets watered down, or the company drifts toward a focus on "competitive practice."

Another clear signal that a business has lost sight of its strategy is when short-term, annual bonus plans reward tactical results. This leads executives to concentrate on achieving the numbers that will produce the highest payouts this year rather than on evaluating the company's progress toward long-term goals. Even long-term incentive plans aligned with the business strategy can veer off course, particularly if the focus is on the wrong goals or measures. Too strong a concentration on the financials obscures a company's ability to focus on the drivers of financial performance.

These all are difficult problems, but committed companies have demonstrated that they can be solved. Companies on the leading edge have recognized that a compensation strategy resembles a business strategy in that it needs to be tested continually to ensure that it continues to match reality. ◆

Compensation Is Only Part of the Whole



Source: Hewitt Associates