



A growing number of chief executive officers (CEOs) are becoming champions and practitioners of *real* executive pay for performance (P4P). Sibson Consulting’s work with clients as well as our recent research — especially the *Real Pay-for-Performance Study*¹ — reveals that these CEO P4P Advocates differentiate payouts to the organization’s most senior executives based on the evidence of each individual’s contribution to the success of the company. Furthermore, they ensure that similar rigor and demands to align pay with performance are applied throughout the executive ranks. As a result, they are confident in the face of increased investor scrutiny and enhanced disclosure about executive P4P. (See the sidebar on page two, “Legislation, Regulations and Reaction.”) Through their pay decision-making actions, they demonstrate to investors that company executives “win” financially only when the investors do the same.

These CEO P4P Advocates have adopted several maxims to guide their differentiated pay decision making. This article focuses on four of them:

- What’s Good for the Goose Is Good for the Gander,
- The Buck Stops Here,
- Show Me Performance, I’ll Show You Rewards, and
- Talk the Talk and Walk the Walk ... But Not Alone.

What’s Good for the Goose Is Good for the Gander

CEO P4P Advocates recognize that performance expectations (and the consequences of underachievement) must be applied seamlessly at all levels in the organization (*i.e.*, “what’s good for the goose is good for the gander”). For instance, participants in Sibson’s most recent P4P study were asked, “Does your CEO use the same approach with the leadership team members as is applied further down in the organization?” the answer was a resounding “yes” at the organizations where the P4P culture was perceived as very effective.

“Our CEO has personal interest in performance evaluations,” commented one interviewee. “He does not hesitate to push back on pay arrangements if they do not reflect performance levels. [As a consequence], our senior executives are driven to be more directly involved with pay differentiation as well, and it all cascades down from there.”

¹ Sibson’s *Real Pay-for-Performance Study* was based on in-depth interviews with approximately 30 companies and was supplemented by a confidential “pulse” survey during the summer of 2010, completed by almost 140 organizations. See the *Fall 2010 Report of Results from the Real Pay-for-Performance Study*: <http://www.sibson.com/publications-and-resources/surveys-studies/?id=155>.

Sibson has observed that the CEO P4P Advocates do not compromise the underlying intent and discipline of the performance management tools and processes used in the rest of the company. However, in applying the maxim “what’s good for the goose is good for the gander,” they do adapt the tools and processes to the reality in the executive suite. Typical adaptations include a simplified yet well-documented, expectation-setting exercise at the beginning of the performance cycle, frequent planned (not *ad hoc*) face-to-face performance conversations and a fact-based evaluation approach that leaves little room for emotional “yeah, buts” from members of the leadership team at the end of the performance-measurement cycle.

Frequently the chief financial officer and the chief human resources officer are key collaborators with the CEO P4P Advocate in the fact-gathering and documentation process. They also may serve as the CEO’s sounding board for payout decision rationale prior to the CEO’s presentations to the board and the compensation committee. Such collaboration facilitates the CEO’s pay differentiation and decision-making efforts. “From the top down, we confidently can demonstrate that payouts are closely aligned with investor returns [and] overall corporate performance and are further differentiated by individual contribution,” commented one CEO.

The Buck Stops Here

CEO P4P Advocates also embrace a second maxim: “The Buck Stops Here.” This means that a leader accepts personal responsibility and accountability for decision-making outcomes. In the realm of performance-differentiated payout decisions for top executives, the maxim operates on two levels. The CEO accepts responsibility and accountability for overall corporate outcomes, and each individual on the leadership team does not blame someone else with respect to the underachievement of individual agreed-upon goals.

An oft-repeated story at one large retail company tells of the CEO’s announcement to his leadership team at the end of his first full year at the then financially troubled company:

Legislation, Regulations and Reaction

Although executive P4P has been a business topic for most of the past decade, the Dodd-Frank legislation* and the Security and Exchange Commission’s (SEC’s) enhanced disclosure requirements** have intensified the focus in recent months. These legislative mandates and regulatory changes enable and encourage increased shareholder scrutiny of the alignment of executive payouts with investor gains and the CEO’s role in creating this alignment. Institutional investment advisors, such as ISS (<http://www.issgovernance.com/>) and Glass-Lewis (<http://www.glasslewis.com/>) also have intensified their “voice” on executive P4P. New analyses, such as ISS’s Governance Risk Indicators (<http://www.issgovernance.com/grid-info>), provide a “graded” perspective on pay practices.

To respond to this increased scrutiny, companies have filled their proxies, annual reports and websites with “evidence” of sound pay practices and the relationship between corporate performance and executive payouts. In addition to numbers-laden charts and tables, corporate disclosure is liberally peppered with frequent assertions such as, “We are a performance culture,” “At our company we pay for performance” and “The objective of our pay program is to align the interests of our executives with those of our shareholders.”

Despite such comprehensive disclosure, for most shareholders doubt remains. Common questions are:

- Do the rewards paid out recognize *real* P4P?
- Are the payouts to the most senior executives differentiated based on the individual executive’s evidenced contribution to the success of the company?

Future SEC requirements to be issued pursuant to Dodd-Frank (especially the P4P chart) are expected to make it easier for investors to know the answers.

* The Dodd-Frank Wall Street Reform and Consumer Protection Act, which was signed into law on July 21, 2010, created rules on executive compensation.

** The SEC approved rules to enhance the information provided to shareholders about risk, compensation and corporate governance so they are better able to evaluate leadership pay decision making at public companies. Future rule-making will establish “standards” by which to evaluate the relationship of executive pay to corporate performance.

I’m not even a three (on a five-point scale). We did a lot of good things, overcame a lot of challenges, but the bottom line is that the company didn’t meet shareholder expectations. I know some of you exceeded the overall expectations I set for you, and you’ll be recognized. The rest of us shouldn’t expect any incentive awards.

In the ensuing years, this CEO continued to set individual performance standards for his leadership team members, which, if achieved, would enable him to fulfill the expectations the board set for him. While there were a few more years without any payouts for both the CEO and some team members, and several team members exited, the company’s overall performance has improved significantly. For the leadership team, there is no ambiguity about the need to achieve performance expectations (and no tolerance for excuses about underachievement). Occasionally, leadership team members get nostalgic for the times when everyone got “a little something” as an incentive payout despite actual individual performance achievement. However, they do respect how the CEO’s “the-buck-stops-here” mindset has resulted in better corporate performance and executive pay that is clearly aligned to that performance.

Show Me Performance, I’ll Show You Rewards

CEO P4P Advocates demand evidence that the performance of executive leadership is worth paying for and translates into shareholder value creation. Thus, “Show Me Performance, I’ll Show You Rewards” is a frequently used maxim.

At performance-evaluation time, CEOs inevitably hear from some of their top executives, “It’s true I didn’t hit all of the specific performance targets you set, but I still should get a decent payout. Just look at all the other things I did, and look at how well the company did in general.” CEO P4P Advocates do not allow individual executives to ride on the shirttails of overall corporate success.

Incentive plans designed to comply with Internal Revenue Service rules under §162(m)² are a common “shirt-tailing” vehicle. Some CEOs believe they are limited by the formula established at the beginning of the year. However, CEO P4P Advocates use the “negative discretion” feature of

A Sample Plan Within a Plan

A midsize financial services company adapted its §162(m) annual incentive plan to maximize the CEO’s ability to deliver performance-differentiated rewards to the top leadership team. Each year, the maximum award payable to each executive is set by a §162(m)-compliant formula, based on corporate performance achievement (e.g., an individual’s award will not exceed X percent of net income). The actual individual award determination, which is calculated at the end of the performance cycle, requires executive performance to be evaluated through two “filters”:

- **Filter 1:** Based on their performance against individual *quantitative* goals each executive preliminarily qualifies for either 50 or 75 percent of his or her individual maximum award.
- **Filter 2:** Each executive’s performance is then reviewed against individual objectives the CEO has set for him or her. Each executive who qualifies for 50 percent of the maximum award under Filter 1 can be awarded an amount less than 50 percent of the maximum award, but no more. On the other hand, each executive who qualifies for 75 percent of the maximum award under Filter 1 can be awarded less than 75 percent, or the CEO can recognize exceptional performance with an award of as much of 100 percent of the individual’s maximum award. By using the “negative discretion” feature of §162(m), the CEO is able to differentiate individual value contribution and promote *real* P4P.

² Section 162(m) of the Internal Revenue Code concerns the deductibility of compensation paid in excess of \$1 million for a company’s top five officers. (Many organizations apply the §162(m) requirements to all §16 executives.) If the rules are not met, compensation paid to an individual in excess of \$1 million is not deductible. Among the rules are the requirements that the awards must be paid from one or more pre-established, objective performance goals. An independent third party must be able to determine whether the goal was met and be able to calculate the amount to be paid. Further, the plan formula must preclude discretion to increase the amount payable, although the company’s compensation committee can retain discretion to reduce a payment (*i.e.*, negative discretion).

§162(m) to allow them to truly differentiate the incentive payouts to top executives based on individual contribution. These “plan-within-a-plan” arrangements can take many forms. (See the sidebar, “A Sample Plan Within a Plan.”)

Many CEOs embrace the plan-within-a-plan approach because it allows them to differentiate incentive payouts to top executives based on individual performance through a tax-favored vehicle that generates reward funding only to the extent that the company’s performance also has met the shareholders’ demand to “show me performance.”

Talk the Talk and Walk the Walk ... But Not Alone

While CEO P4P Advocates recognize that they personally need to be role models, they also know that sustainable success requires broader buy-in. Sibson’s studies and client experience have identified several practices that guide these CEOs as they “talk the talk and walk the walk ... but not alone.” These CEOs:

- Articulate to the total employee population investor performance expectations and how those expectations will translate into *real* P4P at the company,
- Communicate the *real* P4P message to the board and the leadership team at every opportunity through actions as well as words,

Talk the Talk, Walk the Walk ... a Journey Not Taken Alone

The CEO maxims to deliver *real* P4P are exemplified by a global, multi-billion-dollar company whose “journey” began more than five years ago as an initiative to increase the alignment of bottom line performance and pay. Although it was led by the new CEO, he attributes its success to his adherence to the maxim: “Talk the Talk, Walk the Walk ... But Not Alone.”

Five years ago, the company faced the challenges of increasing competition, greater global market opportunity and increased customer demand. To address these challenges, the company needed to shift its focus from revenue growth and an egalitarian culture to profitability and performance differentiation. A chief operating officer/president (later to become CEO) as well as a new division executive were hired. Together, these leaders introduced discipline and accountability to the company’s profitable growth objective and set the stage for elevating performance expectations and changing the company’s mindset with respect to how pay should be aligned to performance.

In the ensuing years, executive level buy-in for a P4P culture gradually increased. Two years ago, there was adequate momentum from the CEO and the other executive champions to implement changes that supported differentiated P4P for senior executives. Among the changes, the company:

- Introduced a more focused performance-management evaluation criteria applicable to incentive award determination,
- Updated corporate and business unit financial metrics,
- Introduced a performance modifier that links equity and long-term incentive cash payouts to the achievement of the company’s new five-year strategy, and
- Implemented a business unit balanced scorecard.* Results against the metrics of the scorecard resulted in an individual performance modifier applicable to annual and long-term incentives. (This modifier ensures that plan payouts reward both the “what and how” of results.)

The CEO reinforced the differentiated P4P mindset shift through individual discussions with each of his direct reports as well as with each of their direct reports. He discussed individual performance expectations and indicated his intent to measurably differentiate rewards based on results.

The results speak for themselves and definitely satisfied shareholders. Results for the past two years exceeded plan and the increase in the overall share price was the second best in the past nine years. Executives, too, are pleased. They feel *they* have contributed to create a corporate mindset in which there is no ambiguity about how individual rewards are aligned to both corporate and individual performance.

* The balanced scorecard is a management system that uses metrics to measure various aspects of an organization’s performance. These measurements are categorized under four broad perspectives: financial, customer, internal business processes, and learning and growth.

- Ensure that the necessary tools (e.g., performance evaluations) and plan designs are in place to support the individual differentiation required for *real* P4P,
- Establish individual executive performance expectations and unambiguously align them to individual senior executive pay opportunities,
- Use regular individual performance evaluation discussions to relentlessly build the number of senior executives who advocate P4P, and
- Focus on the quality of the execution as opposed to just speed of implementation.

(The sidebar on page four, “Talk the Talk, Walk the Walk ... a Journey Not Taken Alone,” describes the success of one CEO P4P Advocate in establishing *real* executive P4P at the company he leads.)

Conclusion

Regulatory mandates and expansive executive pay disclosure requirements enable intense investor scrutiny of the alignment of executive P4P outcomes. In response, CEO P4P Advocates have emerged who embrace P4P principles and practices. They are role models for their organizations as they deliver consistent, tough and differentiated performance and pay messages to individual executive team members. Through their words and actions (and the maxims to which they adhere), these CEOs are well on their way to instituting a *real* P4P mindset throughout their organizations.

About the author:

Myrna Hellerman is a senior vice president in the Chicago office of Sibson Consulting. She advises management and boards in the design and implementation of innovative, effective and sustainable people and reward strategies that lead to improved business results. She can be reached at 312.456.7914 or mhellerman@sibson.com.

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http://www.sibson.com/publications/perspectives/volume_19_issue_1/goose.html.

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