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In Compensation Philosophy

Using Pay to Change Culture

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Members of the compensation committee play a key role in reinforcing corporate culture change through compensation program design and administration.

Many companies, at critical junctures in their life cycles, must transform their cultures to regain or sustain success. A number of factors combine to define a company's culture (see table), but across all factors, pay can be a key lever for sending signals about changes in priorities, influencing behavior, and driving transformation.

Consider two examples of cultural change that a company might undertake: The first, to transition from a focus on individual business unit results to overall corporate results. The second, to reorient from a "growth at all costs" mentality to a more balanced focus on growth with healthy, risk-adjusted returns. Pay can be a powerful driver of change in both cases.

Cultural change is built on three pillars: (i) establishing a "burning platform" for change, (ii) developing the infrastructure to support change, and (iii) ensuring accountability for change — and this third pillar is where compensation plays a crucial role. Each of the pillars is described briefly below, followed by a more extensive discussion of how to use compensation to support and ensure accountability for cultural change.

Establishing a "burning platform" for change. The CEO and the board need to make a case that the need for change is urgent — it needs to happen and happen now. They must do so by definitively establishing that the status quo is a losing proposition, marshaling facts to show that doing nothing is not an option if the company is to survive and thrive. They also need to show how the future can be different and what advantages will be associated with the desired change.

Developing the infrastructure for change. This pillar consists of the following elements:

- Identifying the key elements of the new business model.
- Educating employees so that they understand the new business model, how work will occur differently, and why the new model is important.
- Demonstrating to employees how the changes will affect them — and how they, in return, can affect results.
- Identifying and building the new skill sets that employees will require. In some cases, people will need to change roles. In other cases, the company will need to recruit new talent from outside the organization.

Ensuring accountability for change. First and foremost, the CEO and Board need to agree on the metrics that will be used to evaluate success (and, if needed, the systems needed to monitor and report progress against the metrics should be developed). These metrics can then provide the foundation for a performance management system that includes both monetary and non-monetary rewards for the new behaviors and desired results. In putting this pillar in place, the board needs to make sure the company fine tunes the pay plan to support the new culture.

Example 1: Transforming From a Focus on Individual Business Unit Results to Overall Corporate Results

Consider the case of a manufacturer of consumer durables that hired a new CEO. One of the first observations of the CEO was that people in the company were overly focused on the success of their own business units. Each geography and product unit had its own goals, and an individual's annual and long-term incentive pay was almost entirely based on their unit's satisfaction of those goals. The problem was not that the executives were falling short of their goals, but instead that optimizing results at the unit level compromised overall company success. As a compounding issue, people had become accustomed to negative behaviors: finger pointing when things went wrong, refusing to share resources across the organization, and rebuffing suggestions to sacrifice for the good of the whole.

From an operations standpoint, the picture was bleak: Here was a company with many business units, each making its own product models, each generating duplicative design and manufacturing costs, each competing with the other for shared resources, and all losing out in realizing synergies and economies of scale. By not sharing ideas, the company had developed many products and processes that were sub-optimal. People had created needless variations, resulting in duplication, higher costs, and substandard process control — all of which hurt the company's profitability. As part of his campaign for change, the CEO laid out the elements of a burning platform: the company was bleeding money and losing its once leading reputation, people didn't enjoy working together, and employees detested the "everyone is in it for-himself" culture.

The CEO believed the company needed a new approach, and a new culture. The organization needed to think, and act, like one company. People needed to work together, share ideas, and streamline operations and products. If people worked as a team, the company's many products could be rationalized and improved across a few core platforms, which then could be customized locally to best fit the needs and tastes of their respective markets.

The company created an infrastructure for cultural change through an extensive education program that provided a business case for the shift to company-wide collaboration. It also created a roadmap for change that used cross-geographic and cross-functional teams to streamline company-wide processes and product lines. These initiatives were supported by weekly meetings where interim results were shared and discussed. The purpose of these meetings was to unite leaders from different businesses, encouraging former rivals to elevate and solve each other's most vexing problems.

This was a radical change — moving from valuing the success of individual fiefdoms to valuing the prosperity of the collective whole. In keeping with the third pillar, the company also changed the annual incentive program to put the greatest emphasis on company-wide performance. Metrics at the unit level remained, but were focused on unit level contributions to help achieve the company's overall success. These unit metrics served as a modifier to overall company performance (+/- 25%) and diminished in importance over time as people began to understand and trust the new approach. Judgment and discretion were also employed — in a few cases, formulas were overridden to help reinforce the right choices. The long-term incentive approach was also refocused toward overall company performance so that recipients would focus on the key drivers of company value.

The changes to the incentive programs were also coupled with non-monetary factors such as promotion for "team players" and the celebration of and recognition for successful, collaborative efforts. When used in combination, the aforementioned changes strongly encouraged team play and a "we win together" mentality.

Example 2: Transforming From a Focus on Growth At All Costs To Growth With Healthy Risk-adjusted Returns

A global company involved in commodities trading wanted to improve the deal-making of its traders. While the traders were making deals that grew the top-and bottom-lines, the profitability of these deals was not always commensurate with the associated risks. In particular, the CEO was concerned that the company's cultural focus on growing accounting profits (but not economic profits) was destroying shareholder value.

To promote change, the company embarked on a campaign to demonstrate to traders why the company was losing value. In educational sessions, they reviewed the results for each trading area over the last five years. The review showed that, even though 95 percent of trades were profitable, over half were not profitable enough to earn more than the risk-adjusted capital costs. The data clearly showed that the economically unprofitable trades were destroying enterprise value.

In keeping with the final pillar of culture change, the CEO and board redesigned the performance measures underlying pay. The new measures subtracted a risk-adjusted capital charge from trading profits to eliminate the illusion that accounting profits (and not economic profits) were sufficient. Thus, pay reinforced a culture with greater prudence — prudence in taking action that actually created value for shareholders.

Though pay remains essential for reinforcing cultural change, sudden changes can jar an organization. This suggests that the board compensation committee should balance change with stability and a reasonable sense for the pace of needed change. One key success factor is offering education and training during a transition period. Such a program can help employees understand why a new program is needed, what new metrics will be used to gauge success, and how they can impact them.

Sometimes, it can make sense to change pay in a stepwise fashion. There are frequently trust issues and/or inertia to overcome, and initiatives take time to mature before they bear fruit. In this second example, as the CEO initiated changes, he championed a sequenced approach to goal-setting for future performance periods. Targets were set with the recognition that a culture does not change overnight. The targets for the first year called for only modest improvements. Targets for the second and later years rose to more aspirational levels, which gave employees time to adjust. Another stepwise approach is to pilot new metrics in the first year with no tie to pay, and then attach them to pay in year 2.

In all cultural change efforts, pay should be part of a continuous-improvement process with reinforcing elements: New thinking. New strategies. New behaviors. New measures. New feedback loops. New pay elements. The parts all work in a virtuous cycle. People then move naturally from the old to the new. In effect, the pay system is a signaling system: It reminds people that the change to a new culture is real — and everyone in the company is a part of driving the company to a higher plane of performance.

Defining Aspects of Culture	Illustrative Levers for Pay Design
Importance of team versus individual	• Relative emphasis given to team goals (e.g., corporate, division, function) vs. individual goals • Degree of variance in actual pay delivered to individuals
Degree to which risk-taking is encouraged/discouraged	• Degree of leverage and upside in incentive plans • Incorporation of risk-related metrics • Mix and design of long-term incentive vehicles (e.g., options vs. full-value shares) • Inclusion of deferral and clawback features • Extent to which judgment and discretion are used vs. purely formulaic approaches
Tolerance for and encouragement of change	• Inclusion of non-financial goals (e.g., especially related to change/innovation) • Periodic review of pay designs to reflect evolving strategies and business models • Use of flexible approaches to reward innovative ideas and their execution (e.g., use of special awards and programs) • Sufficient judgment to not unduly punish “failures” deemed acceptable
Hiring for long-term careers versus swinging door	• Career-oriented pay designs vs. short-term or transactional pay schemes • Appropriate opportunities for reasonably spaced promotional pay (along with supporting systems) • Appropriately structured and sized pay for those on developmental assignments
Long-term vision versus short-term needs	• Relative weight given to long-term pay vs. annual pay • Adequate length of long-term performance cycles • Ongoing programs versus mega awards focused around milestones • Stock ownership requirements • Inclusion of strategic measures in annual incentive plan

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