CHAPTER 7

Total Reward Architecture

Why We Talk About "Architecture"

When we talk about building executive total reward strategies, why do we use the word "architecture?" Because if you compare building your strategy to building a house, things suddenly seem a lot clearer!

If you were thinking about building a house, what would be your first step? Deciding what kind of house would fit your needs, right? For example, an English Tudor is going to fit a very different set of needs then, say, something *a la* Frank Lloyd Wright. A one-story ranch may be more convenient for those who—for whatever reason—appreciate one-level living. On the other hand, a sprawling, multi-level Colonial might meet your very specific aesthetic needs. When you build a house, you prioritize what's important to you based on the occupants of the house. You decide whether, for example, convenience or aesthetics will drive your construction decisions. Same thing with building a total executive reward strategy. You take a good, long look at the company—it's environmental factors, key stakeholder issues, vision, mission, and values, business and people strategies—and decided what kind of total reward architecture will best fit the company. But instead of deciding whether to go rustic Cape Cod or reproduction Victorian, you are thinking about things like whether it better suits your company to pay for organizational or individual performance, short- or long-term performance, etc. However, the concept is the same.

If you've ever built a house, you know there are a lot of steps to complete before you can throw a respectable housewarming party. If you could just decide what type of house you wanted and call it a day, building a house probably wouldn't be an oft-cited reason for divorce. The fact is, once you've decided what kind of house you are going to build, you've got a lot of details to deal with. How big will the house be? Will the house be one story,

Example Messages for Executive Reward Strategy

Pay for Which Organizational Unit? Individual Team Group/Unit Organizations	**Pay for What Duration of Time Frames?** Short-term Middle-term Long-term Life-term
Pay for What Type of Performance? Incremental performance Restructuring	**Pay for Which Performance Levels?** Absolute performance Relative performance
Pay for Ways to Measure Performance? Contribution/effort Results Competency/Knowledge/Skills Behaviors	**Pay for Which Business Stage?** Start-up Emerging Growth Mature Decline
Pay for Which Types of Time Frames for Performance? Projects Milestones Termstones	**Pay for What Performance?** Look forward/Plan Look back/History Look around/Competition

or two? How many bedrooms? How many bathrooms? Will the garage be attached or separate? And just when you think you've got all that out of the way even more details come down the pike. Copper roof or asphalt? Aluminum siding or cedar shingles? Granite countertops or soapstone? Cherry cabinets or birch? Should that extra room on the first floor be a library for her or a card room/bar for him and his buddies (if they decide to go the latter route, we hope one of the buddies is a marriage counselor)? And how will you set up the electrical, plumbing, and heating systems?

Just as you build a house in steps, you should look at constructing a total reward architecture in steps as well. The first step is to determine the needs of your company and decide what kind of strategy you are going to put in place. Just as you would first decide what kind of house you are going to build, when building your total reward strategy the first thing you should do is determine what the goals of your strategy are. Again, look carefully at the factors previously discussed in this book—business environmental factors, key stakeholder issues, vision, mission, and values, business and people strategies—and decide what kind of reward structure would best help your company reach its goals.

Coming In for the Close-Up

As we hone in a little closer on total reward architecture—we're hovering around 15,000 or so feet here—the way in which executives are linked to business outcomes should become more apparent. You've got a lot of information, from how outside business environmental factors affect your total reward strategy to how organizational structure, processes, and culture affects your plan. The key now is to take your information and leverage it in a way that motivates your executives. It all comes down to the age-old question, "What's in it for me?" In order to best answer that question you've got to have knowledge of the business, and you've got to use that knowledge to motivate executives through rewards. The goal here is to align the successes of the company to the successes of your executives. We don't care how fun someone's job is, if they aren't being compensated in a way that is meaningful to them, they aren't going to show up. Or in some cases they are going to show up—if they have the corner office at Victoria's Secret, say—and that's about it. But is that going to go very far in helping you meet your desired outcomes? Doubtful.

So back to the question, "What's in it for me?" How best to answer it? Like we said before, the first step is to leverage everything you've learned about your company in a way that links executive success to overall company success. The next step—and this is critical—is to demonstrate to executives how that connection is made. How do you do this?

If only we could write a paragraph or two here under the subhead "You Have Found the Holy Grail" and call it a day. No such luck. There is no one path; there's no silver bullet. As you've learned in previous chapters there are just way too many permutations and combinations for there to be a one-size-fits-all answer.

But the good news—and yes, there is good news—is that you've done enough homework up to now to know that while there's no chartered bus to take you to your destination, there is certainly a navigable road map if you are willing to take the time and effort to drive yourself. What's the most effective kind of executive rewards strategy? One that allocates rewards in a way that directs the business to meet its goals and objectives. When developing your plan there are three factors that will make up the reward plan's total value. Used correctly together, these three strategic axes provide all the leverage you need while communicating to executives how their success is linked to the success of the company. So what are these three strategic axes? We like to call them the three Ms—money, mix, and messages.

Let's quickly define money, mix, and messages.

Money. What's money? Just what it sounds like. It is, when all is said and done, what the executive is compensated. It's the element that is considered to be the rewards in the marketplace where you compete for talent and the competitive levels that you establish for yourself in those marketplaces. We like to refer to money as the competitive market attachment. Money is the level of rewards, and is how total rewards are defined in terms of total cost to the company (internal) and relative competitive level (external) of the total of all of the rewards components paid to the executive.

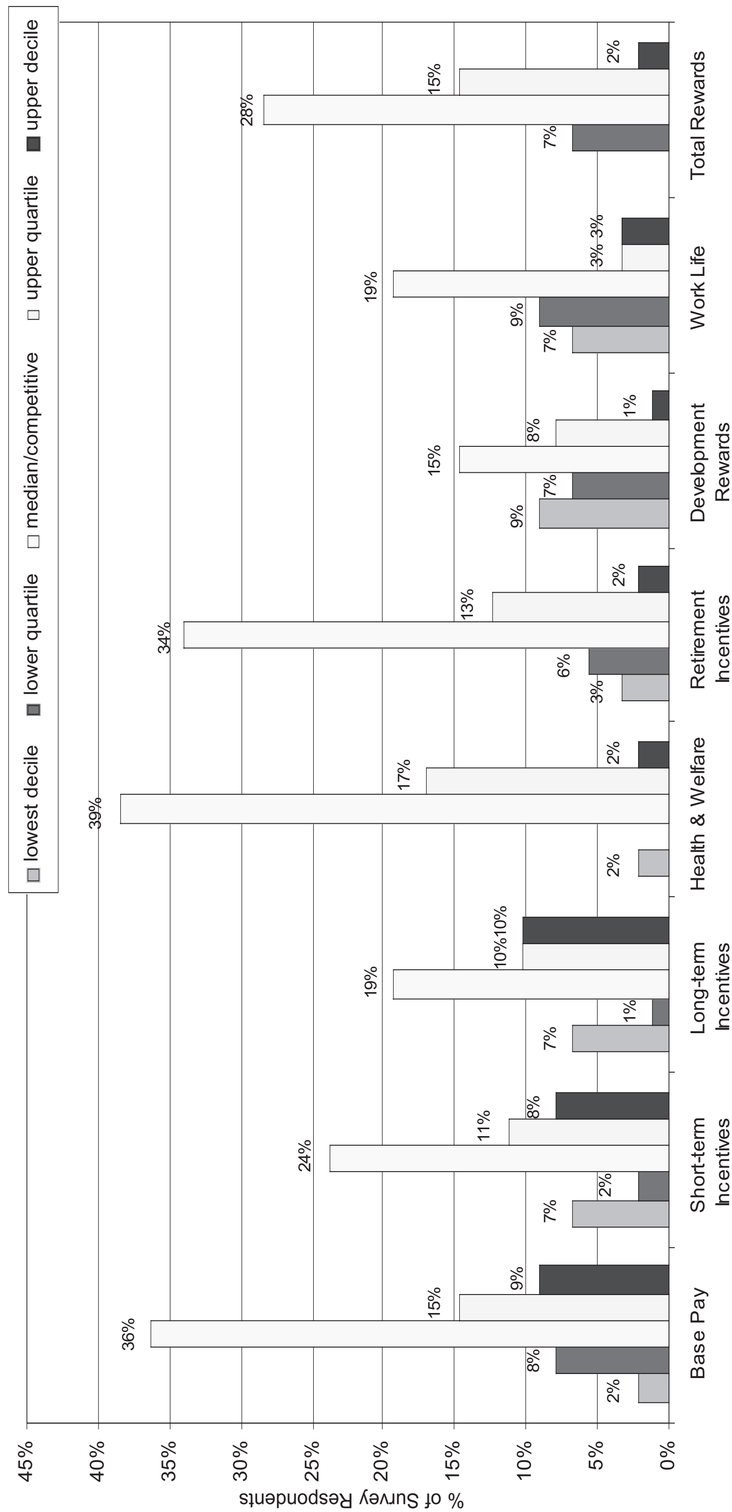
Mix. This strategic axis answers the question of how the total executive reward strategy is balanced between various reward components, such as base salary, short-term incentives, long-term incentives, benefits, perquisites, and developmental rewards. For example, is the overall program more fixed, or variable? Mix is how an executive total reward architecture is designed to distribute the reward elements most successfully.

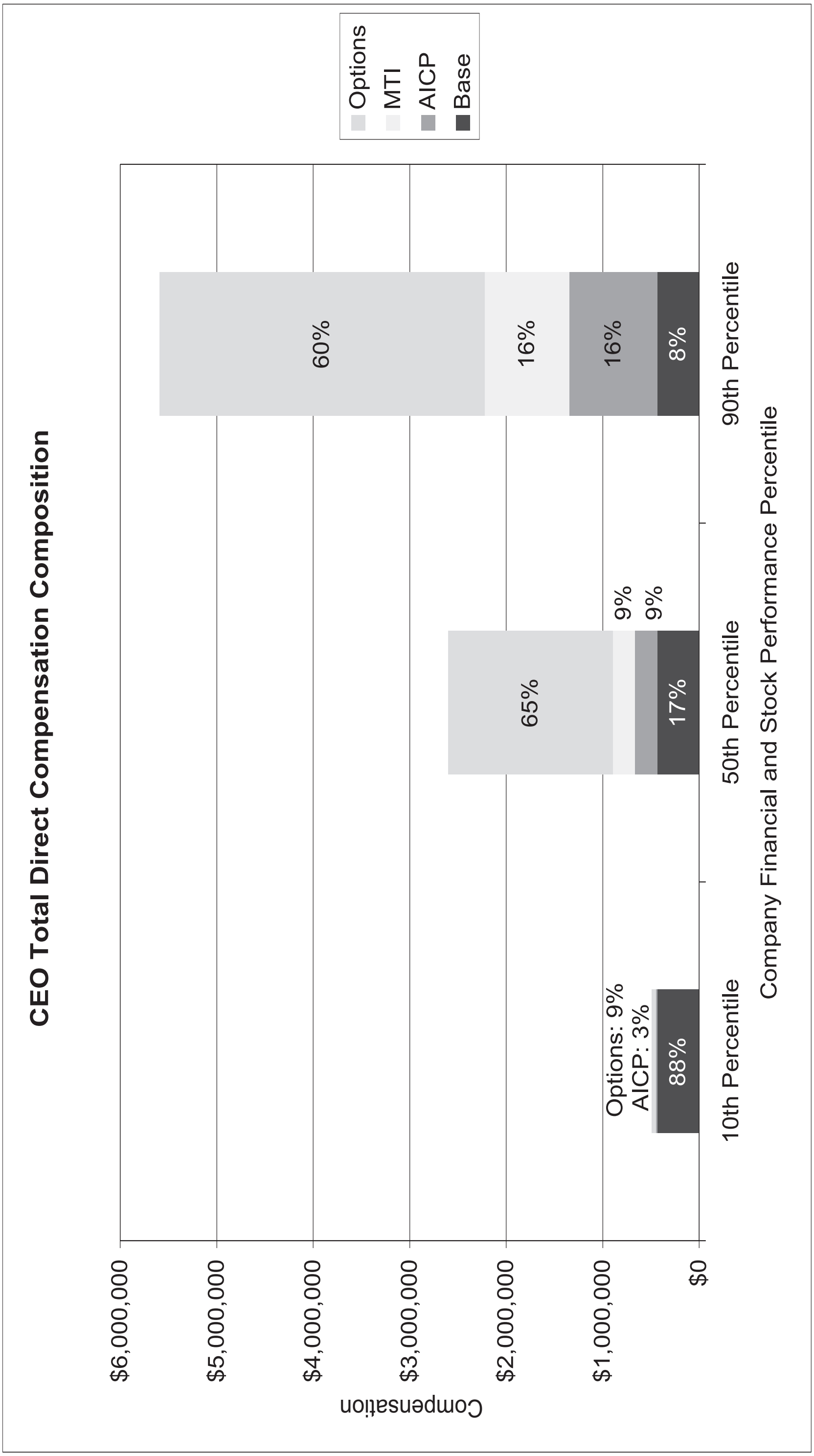
Messages. Messages answer the final question of "why." Messages tell executives what the desired business outcomes are, and align the plan with people's efforts. You can look at messages as the philosophy behind your total reward program. Messages should make it clear to everyone what the reward plan is designed to accomplish.

n organization about to become an IPO came to us with a difficult situation. The two founding members of the organization were the two key sales individuals for the acquisition. The founding individuals wanted to be

The Position in the Market to Which Companies Actually Anchor Various Components

Executives




CEO Total Direct Compensation Composition
Compensation
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88%
AICP: 3%
Options: 9%
17%
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65%
8%
16%
16%
60%
10th Percentile
50th Percentile
90th Percentile
Company Financial and Stock Performance Percentile
Options
MTI
AICP
Base

Performance Measures: Examples by Type

Measure Type	Examples	Pros	Challenges
Capability Measures	Employee satisfaction/Turnover Response time/Time to market Staffing/Employee profile	Generally more directly controllable than other financial or shareholder measures Recognizes difficulty of financial, shareholder value goal setting Recognizes very long term objectives	Human capital value chain relationships to financial and shareholder value measures is poorly understood Requires strong ability to identify the key objectives
Operational Measures	Budget vs. actual Process quality Reliability/rework Accuracy/error rates Process improvements New product introduction	Generally more directly controllable than other financial or shareholder measures Recognizes difficulty of financial, shareholder value goal setting	A limited number of objectives may not adequately recognize business complexity Requires strong ability to identify the key objectives
Financial Performance Measures	<u>Income statement</u> Revenue, revenue growth Gross margin, gross margin growth Operating income, growth ROI, ROI growth EBIT, EBIT growth EBITDA, EBITDA growth <u>Balance sheet</u> Debt management Asset management <u>Blend</u> Earnings per Share Return on Invested Capital (ROIC) Economic Value Added Return on Assets Cash flow, cash flow improvement	Familiarity Simple approach -- measures outcomes, not process Blends begin to reflect investor expectations	Generally modest relationship to long term shareholder value growth Line of sight is weak for most employees Understanding of measures is weak for many employees
Shareholder Value Measures	<u>Actual</u> Share price appreciation Change in market capitalization/MVA Total shareholder return <u>Pseudo/Indicators (positive correlation to SV)</u> Economic Value Added ROIC Return on Capital Employed ROA	Clear or clearer link to shareholder value May be effective for short to mid term Pseudo/indicators Best reflection of competitive nature of business, inherent risk and uncertainty	May not adequately recognize true long term objectives Pseudo/indicators may be difficult to understand; may require new measurement tools, processes Line of sight is very weak May be difficult to measure at local levels

> *called "Co-CEOs." They also generated the majority of the revenues for the organization. The dilemma: we couldn't pay two CEOs for one job.*
>
> *The solution was to cut the baby in half. We gave each CEO approximately half of the salary and incentive they would have received as sole chief executive officer. We also provided them with a unique producer bonus. The producer bonus provided them with a similar amount of compensation based upon their sales efforts.*
>
> *Sometimes the Solomon solution is the right solution. There's nothing wrong with designing half-assed programs if you've got a half-assed situation.*

When you put money, mix, and messages together, you have what we have been calling "total reward architecture." Let's go back to our house building analogy for one second. Once you've decided what type of house you are going to build, the next step is to determine its layout and features based on your family's needs. In comparison, money, mix, and messages are the layout and features of your total reward strategy based on your company's needs. Just like no two families are exactly alike, nor are any two businesses. The total reward architecture—the money, mix, and messages—will be unique to each company. You've probably figured out by now that we don't always stay within the lines, and for that reason you'll never find us suggesting the "standard" division of 30 percent salary, 30 percent short-term incentive, and 30 percent long-term incentive.

Again, the money, mix, and messages that comprise a total reward architecture will vary from company to company. However, here are a few objectives for what every organization's total reward architecture should be:

- A function of the organization's overall size, as well as a function of performance;
- A function of the division, group, and/or team performance;
- A function of individual executive performance;
- Easy to communicate and easily understood by all participants;
- A regular portion of the business metrics;
- Able to tie high performers to the organization;
- As small a change to earnings as possible.

A successfully designed program can draw linkage between the relative influence of the external environment, key stakeholders, business strategy, organizational capabilities, and people strategy on money, mix, and messages.

Money, Mix, Messages and the External

Environment and Key Stakeholders

When it comes to the influence of key stakeholders and the external environment on total rewards, company ownership, the regulatory environment, and competitive posture are three of the biggest factors. Let's take ownership as an example. A company's owners have a big influence on how rewards are allocated. When it comes to mix the fewer the owners the higher the variable and the more they focus the reward program message on financial returns. Companies with many owners have more moderate variable, and the reward strategy tends to send a message that the organization is striving to serve its many stakeholders.

ne of our hedge fund clients asked us to develop a total reward strategy. At the time the CEO of the organization owned 85 percent of the company, with a prior investor owning the other 15 percent. All of the traders received annual bonuses in the form of cash plus a small deferral. The CEO wanted the individuals to have more incentive over the long term, as well as a stake or an amount of equity in the firm to ensure the long-term viability of the organization.

We designed a modest deferral of current bonus for the purchase of equity within the organization, after an initial small investment in the form of equity was given to some of the key trading people. To this day we feel the amount of equity given to the individuals was far overshadowed by the amount of value that would accrue to the individual trader on an annual basis. Ultimately, before we even finished the design or implemented the plan, the hedge fund blew up as result of one of the traders making short-term bets on the price of energy. We'll never know whether or not the change from a 100 percent short-term basis incentive program to a more balanced short- and long-term rewards program would have encouraged the individual to reconsider his extreme bets on natural gas.

Sometimes you have to realize that when the rewards are extremely high and the risks are also very high, rebalancing the program is an imperative that needs to be done much faster and much larger.

Whether or not a company is heavily regulates will also determine reward design. When it comes to money, the degree of government regulation impacts the free market for organizations and employees. When it comes to mix, the degree of government regulation impacts whether the product is system controlled versus employee controlled. And when it come to messages, the degree of government regulation increases and decreases the risk orientation and time frame.

university came to our organization with serious concerns about retaining their two key investment professionals. Other universities had lost their key investment individuals to the hedge fund industry.

The investment professionals were paid a reasonable salary, with a short-term incentive plan typical of endowment incentive plans. The upside based upon superior performance was modest. The downside based upon extremely poor performance was not very penalizing. The individuals had performed between the 80th and 90th percentiles of all endowments in the United States.

We decided to fashion the reward strategy upon the direct competitors in the hedge fund industry. The professionals would receive substantial upside compensation when performance was superior, but would suffer hedge-like consequences should they perform badly.

Sometimes when designing a total reward strategy you can't look at the way direct competitors pay their people if the direct competitors are losing their people to other types of organizations. You're better off looking at the way the organizations recruiting your people are paying their individuals.

Finally, where a company stands in relation to its competitors will also be reflected in its reward strategy, since this factors in to the ability to attract, retain, and motivate executives. How an organization's products and services are viewed by consumers, how that position in the marketplace affects executive perception, and what the organization is best known for should also be reflected in the messages sent by the total reward strategy.

INVESTOR ALERT

INAPPROPRIATE COMPETITOR BENCHMARKING

As the saying goes, we wish we had $1 for every time a CEO gave us a list of their competitor companies, only to find said "competitor companies" were much larger when it came to size and performance. We would be rich indeed.

This is probably just a case of someone comparing themselves to someone they aspire to. And that's fine. We like CEOs who shoot for the stars. We usually deliver a cream-of-the-crop group of competitive companies to those individuals—but only after providing them a group of companies that are comparable to themselves in size, industry, and performance.

Money, Mix, Messages, and Vision, Mission, and

Values

Lots of organizations think they have vision, mission, and values. The question is whether or not vision, mission, and values is understood and put into practice. If it is, it can be—and should be—used as leverage in your executive total reward strategy. How much should you link these things to compensation? That's easy. The extent to which they are used in your organization should determine the extent to which they are linked to compensation.

When it comes to money, a good tactic is to pay for what the company values. For example, if your organization depends upon customer service for success, make sure you pay for it. As far as the mix goes, it should speak directly to how far into the future your vision extends. For example, if your vision statement focuses on three to five years from now, rewards should be structured for the long term. Finally, when it comes to messages, use vision, mission and values to determine whether what you are paying for will drive executive behavior to reach the organization's goals.

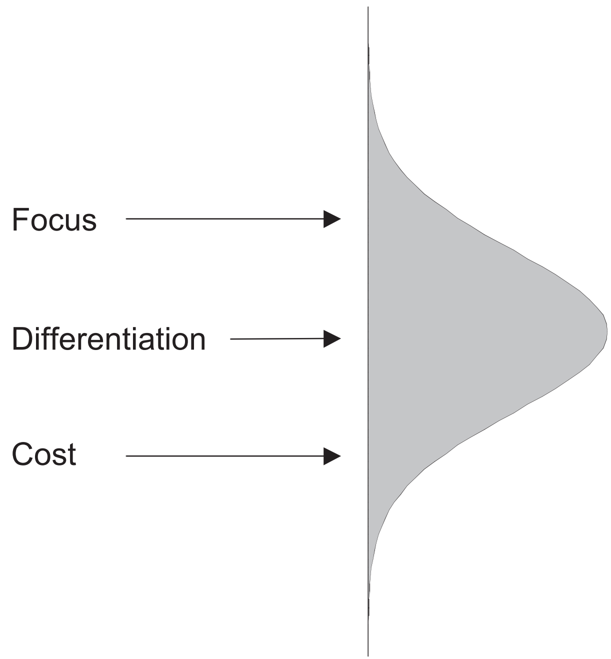
Money, Mix, Messages, and Business Strategy

The first step in linking executive rewards to your organization is to completely understand the organization's general business strategy (GBS). You want everyone to know how you compete; for example, if you compete on research and development, you need to make sure your reward plan is structured so that executives don't forget that, and when all is said and done you reward for research and development. That's how you'll get your message across.

Both money and mix will vary greatly depending upon the GBS. For example, an organization with a GBS focused on low cost might have a lower fixed, higher variable mix of components that focuses on the long term, while an organization that focuses on differentiating its product in the marketplace might have a mix that balances short- and long-term rewards. The message conveyed in the reward strategy in the former company might be to focus on points in the process where costs can be impacted, while the message conveyed in the reward strategy in the latter organization might be to focus on standing out from the competition by being different.

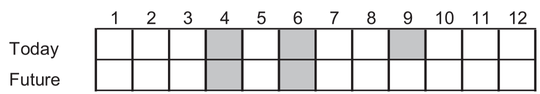
Value chain strategy (VCS) can be used to deliver a message of how and where executives add value to an organization's products or services. When it comes to money and mix, focus on the critical links in the value chain and reward the right people and actions. Rewards should make it clear how each link in the chain adds value, and the mix should reflect the emphasis.

General Business Strategy

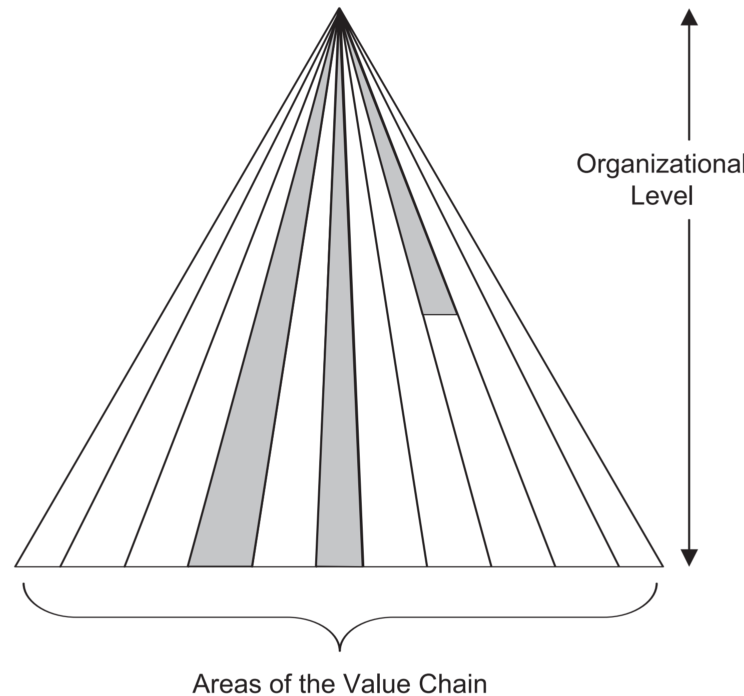


- **For any given position, there is a range of market pay levels**
- **The General Business Strategy helps to shape an organization's overall target pay position (across all positions)**
- **Typically:**
  - An organization that competes on a Cost basis will pay, on average, below the 50th percentile
  - An organization that competes on a Differentiation basis will pay, on average, near the 50th percentile
  - An organization that competes on a Focus basis will pay, on average, above the 50th percentile
- **An organization's General Business Strategy is typically consistent year to year and changes over a 5 to 10 year time horizon**

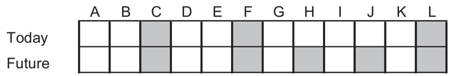
Value Chain Strategy



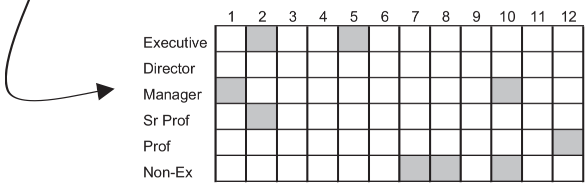
- **The Value Chain Strategy helps to shape the target competitive position *for functional areas* within the organization**
- **Areas of competitive advantage would typically be targeted higher versus the external market (in comparison to other functions within the organization)**
- **Where the competitive advantage is in the future, an organization may target particular organizational levels (where responsibility for implementing change may reside)**

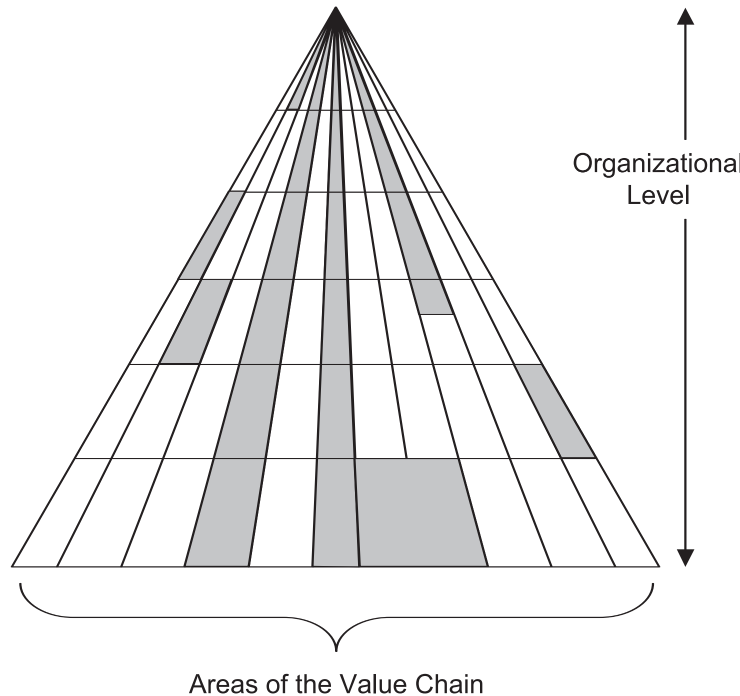


Specific Business Strategy



Organizational Capabilities





- **The Specific Business Strategies (SBS) and the Organizational Capabilities (OC) help identify areas of the organization to target differentially versus the external market**

- **The end result is an organizational “map” that identifies the market attachment strategy**

When it comes to specific business strategies (SBS) they vary so much that it's hard to get into particular strategies. However, we can offer one piece of tried-and-true advice: be consistent! Just make sure that the money, mix, and messages give your executives a clear indication of the direction in which you want them to go, as well as what you want them to accomplish. Specific business strategies fall into the categories of growth, value chain optimization, and maintenance/reduction. If those are understood and properly communicated, a properly designed reward program can heavily influence their success.

e were called in by a large instruction organization to assist them in integrating their five most recent acquisitions into a single consulting organization. None of the acquisitions had been integrated into a single reward strategy, nor had they been integrated into the organization overall.

To make matters even worse, each of the individual acquisitions had been given a different buyout formula. Since each organization negotiated a different buyout formula and a different set of buyout performance factors, the entire organization was headed in five different directions with no interest in working with each other to create the synergistic effect proposed as a rationale for the actual acquisitions. Not only was the result a clash of objectives and egos, but ultimately none of the key executives within the organization had any real desire to work with the parent organization if it meant a decrease in their buyout incentive payments.

In this case we recommended developing an overall total reward strategy for the five organizations, starting with the broad-based employee work force and using the five key acquired executives as designers of a single integrated reward strategy for their new entity. All five executives worked as a team to develop the new unified reward strategy for the overall organization, which gave them a good working knowledge of the organization's overall business strategy.

Sometimes it's not the results but the process. In order to create the required trust and credibility of the process, it was necessary to co-opt the executives into running through the process once for their employees, and a second time for themselves. The first time allowed them to develop a common goal, while the second time allow them to make the compromises necessary because they understood and trusted the process.

Money, Mix, Messages, and Organizational

Capabilities

The money dimension should feel lots of influence from organizational capabilities. If you've determined where along the value chain importance lies, you can focus rewards on where leverage from capabilities is the most significant. Mix can be used to organize rewards, and put the emphasis in the results and actions—as well as those behind them. The message here will be clear.

Money, Mix, Messages, and People Strategy

When it comes to structure, rewards should be aligned with how people move within the company, as well as whether the organization is focused on being functional, geographic, product/service-oriented, or process-oriented. The layers of management will drive the mix, while the characteristics of the structure—the number of layers and the predominant themes—will influence messages.

As far as culture is concerned, the three Ms do much toward defining an organization's personality. Money and messages are used to attract and retain the people who define the company's culture, while mix and messages motivate those same people to keep behaving in a way that continues to define it.

It's Getting Hot in Here

How much do the external business environment and key stakeholder issues affect plan design? Dramatically. Just consider the heat that shareholders, boards, and even the general public are putting on companies to cut down on exorbitant pay and keep ethics in check. How do you think shareholders of Marvell Technology group reacted when Sehat Sutardja saw his paycheck explode 14,000 percent in one year as a result of cashed-in stock options? You could practically hear their blood boiling. But what is worth mentioning is that while most companies who earn so-called "celebrity status" have been involved in activities like backdating scandals, most of the companies that haven't been in the limelight have tried to improve their total rewards strategies. One of the major impetuses for change came from shareholders who were concerned that executives were getting giddily rich off of stock option plans. The logic behind this plan wasn't so bad. The idea was that executives who were sold future stocks at a current price would do everything to ensure that stock prices rose as much as possible.

Nice idea, but while CEOs were encouraged to ensure that stock prices rose as much as possible, this was only until the future date at which the shares were valued. From that point forward the executive had little—if no—incentive to see share prices continue to rise. There were other flaws too: high share prices as a result of "hype" meant the company's effectiveness and profitability were ultimately damaged, not to mention that the set-up made "backdating" not only possible, but very tempting. Options at Tyco and Enron, for example, certainly didn't prevent and may have even encouraged the widespread accounting frauds at either company.

So what's the result? As executive after executive enjoyed—we use the term loosely, of course—his 15 minute of fame, the external environment and key shareholders did their best to ensure that the ethics-free period was over. They had lots to say, and the government was listening. According to the 10th Annual Corporate Board Effectiveness Study, 40 percent of directors thought that pay for CEOs was "too high in most cases," and 81 percent favored increasing the link between CEO pay and performance (1). Sarbanes-Oxley and the new SEC regulations are designed to keep companies from straying outside of bounds when it comes to executive pay. We won't know for a while whether these sweeping pay disclosure rules will manage to contain the executive pay beast. But our guess is that outside influences will most certainly play a part in reining in ridiculously large paychecks.

As a matter of fact, companies are already bidding *adieu* to the "pay for a pulse" mentality. A good example is Smithfield Foods, which modified CEO Joseph W. Luter's pay plan so that he received a bonus only if the company surpassed $100 million in earnings (2). Other companies are following suit by responding to investor outrage by spending more time on more creative compensation strategies. Some recent trends? Bonuses based on how a company compares to its competitors, elimination of guaranteed minimum pay, and severance accords that prevent big payouts despite poor performance.

Shareholders are driving the "new normal" in executive compensation. They are influencing the size and features of total rewards strategies, with an emphasis on looking at all elements of compensation. Thanks to shareholders, companies are saying goodbye to the almost exclusive use of stock options and are instead changing the long-term mix to a blend of options, restricted stock, and performance shares.

INVESTOR ALERT

75TH PERCENTILE PAY FOR 50TH PERCENTILE PERFORMANCE

Whenever the executive compensation program is targeted at the 75th percentile for the purpose of retaining the 50th percentile performing management, there is a pretty important disconnect.

Call us simple, but to pay above-average compensation for average performance just doesn't seem correct or fair to shareholders or management.

If we were investors and saw an organization that stated it wanted to pay the 75th percentile for target performance, unless we could truly determine performance was at the 75th percentile, we would target some other organization—one with a more reasonable pay and performance relationship—for our investment.

Peer Pressure

In many cases, boards and committees throw in the towel and decide to do what other successful companies are doing, in the hopes that they'll get the same results.

Flawed logic, at best. Your company can be in the same industry, with the same amount of employees, but unless your environmental and key stakeholder issues—vision, mission, and values, business and people strategies, and organizational structures—are identical, you are going to require a unique total reward architecture with a unique set of money, mix, and messages. Are you going to get the same results just by copying the other guy? Not likely. What helps a company with one strategy, culture, and environment might really hurt another. What makes your company successfully may be very different from what similar companies are doing. Companies who are practicing this type of lackadaisical benchmarking need to slow down and ask themselves one simple, basic question: Will this total reward architecture that we are considering motivate our executives and enhance company performance?

Another problem that causes a poorly structured total reward architecture is when boards and committees follow ideologies that, while deeply believed in, are relatively unexamined. The use of stock options as a compensation strategy is a great example. Everyone jumped on the stock option bandwagon, thinking they were a great way for cash-strapped companies to ensure executives worked their tails off making sure stocks performed. In reality, the stock option craze led to an ethical nightmare in which executives were motivated to take a short-term, selfish view. Senior executives lied about their companies' performance, "hyped" their stock, cut nefarious deals. And were rewarded for it, even as companies went bankrupt and shareholders were left with nothing. And yet more and more companies continued to jump off this bridge just because others were doing it. The companies with the best total reward architectures don't allow ideologies to get in the way of examining all the data necessary to determine the right money, mix, and messages. The companies with the best total reward architectures don't follow another company's lead without demanding proof that the plan will work in their favor.

The Stories of Miller and Diller and a Few Others

Let's go back to that questions we asked a while ago that all committees and boards ask themselves. The question is, "How much is enough?"

Again, there's no right answer. Even at the top, there are different views when it comes to the paychecks of CEOs. If you don't believe us, consider Biomet Inc.'s Dane A. Miller and IAC/Interactive's Barry Diller for a study in two contrasting opinions.

Let's talk about Miller first. When money was tight in Biomet's early days, Miller cut his salary by 25 percent and took home $12,000 (3). No, we didn't leave off a zero or two. Granted, this was all 28 years ago, but still. Today Miller, who is still at the helm, takes home a little more than half a million, a paltry sum when you compare it to those of other executives. The company's four other officers receive similar amounts.

But Biomet's low pay pyramid works for them. Today business is booming, and has enjoyed profit and revenue growth ever since that first year. How come?

According to a University of Notre Dame Study that tallied the top five executives at 460 companies from 1992 to 1997, a narrow pay gap at the top reduces management turnover. Executives were much more likely to leave companies with big gaps in pay distribution, regardless of the actual figure (4). Biomet's philosophy emphasizes group decision making and compensation is based on how much authority a person has. And its low pay pyramid is in perfect alignment with that philosophy. Biomet preaches moderation, and Miller, who has never taken stock awards, and has no pension, employment contract, or golden parachute, sets the example by walking the talk. So is it *really* about how much? Nope. It's about structuring money, mix, and messages in a way that encourages executives to operate in a fashion that leads to the success of the company. Biomet's compensation strategy works because it has been the basis for the company's management style since the beginning.

Now let's take an example for the other end of the spectrum. Who won the award for the biggest paycheck in 2005? The golden pig statue went to Barry Diller, CEO of IAC/Interactive. Two different companies estimated his total compensation—Corporate Library said his paycheck logged in at a hefty $295 million (if we did our math right that's about $14,000 an hour; we hate to state the obvious, but that's a lot of money)—Glass Lewis & Company figured he was paid $85 million (5). While both services used different methods to calculate the final damage, both agreed Diller was the highest paid executive.

What else did both companies agree on? Both companies agreed that the company's performance—down 7.7 percent in 2005—didn't merit such obscene pay. Most of his compensation—less his relatively normal $726,115 base salary in fact—was made up mostly of stock options. Sure, stock options are often given to CEOs as motivation to improve performance, but when you've accumulated the amount of wealth that Diller has, do you really think the extra stock options are going to keep him in the office past 5? Not likely. Had the board or compensation committee really thought about it, there was probably a much better way to allocate money, mix, and messages that would have ensured a better return for the company.

For now, shareholders continue to contend with the daunting task of linking pay to performance. The 1980s brought us the idea that tying cash bonuses to rising sales or earnings would boost performance. And what was the result? Executives made decisions based on short-term results that often yielded long-term catastrophes. In the 1990s stock options were the hopeful "quick-fix" *du jour*, and we all know what happened as a result. Were executive's fortunes tied to those of shareholders? Hardly. The CEOs got richer, while the shareholders were often left holding useless pieces of paper. So what's the moral of this story? There is no "quick fix."

However, there are some new trends looming on the horizon. Companies are rethinking the different components that make up pay packages. Safety nets like golden parachutes and hefty "see ya" severances are no longer standard. Companies are trying to motivate executives by linking components like bonuses and the vesting of restricted shares to performance. The examples are all over the place. Check out John R. Alm's arrangement. Alm, the CEO of Coca-Cola Enterprises, has a contract that says he'll lose all his restricted stock if he isn't still at the company when his shares vest in five years. He'll also forfeit all the shares if the stock price has not climbed 10 percent at vesting time, and he will lose half of them if it has not increased by 20 percent. So do you think Alm is pretty motivated, or what? This is a great example of a company doing an excellent job of disclosing a total pay package and how they play out in different scenarios. The goals of the company, as well as how Alm's success is linked to them, are crystal clear.

Slowly but surely, companies are responding to shareholders' call for total reward packages that reward executives who think long term. Many companies, Cardinal Health comes to mind, are structuring their pay packages so that executives and directors hold about five times their pay in stock, making it harder for them to cash in on any short-term boon. What message is this sending? It's sending the message that executives will not benefit from a short-term gain that isn't sustainable. Some companies are moving away from grants of restricted shares that vest after three to five years. Instead, companies are giving shares that vest only if the company hits certain measures that correlate to its success. What does this mean? It means that executives who aren't helping the company reach its goals may not enjoy the same kind of happy and carefree retirement of yesterday's executives.

Mix Masters

Do big-time executives care more about getting rich than increasing shareholder value? Well, CEOs are human, just like you and me. To be quite honest, some of the stock option offerings that executives were offered in the 1990s and the early part of the 2000s were begging to be abused so badly that you would have to be Mother Theresa not to bite. In these cases, the mix wasn't mastered.

Even General Electric Corp.'s chairman and CEO Jeffrey Immelt, who oh-so-nobly declared that his $15 million compensation package and $14.6 million worth of performance shares were structured in a way to "totally align" his interest with that of shareholders, missed the boat. Somehow Immelt's exorbitant paycheck wasn't structured in a way to help him make the decisions that would bring GE success. Since Immelt took over General Electric has, for the most part, lagged behind other big companies. GE's proxy stated $100 invested in GE at the end of 2000 would have been valued at $82 at the end of 2005 (6). In comparison, the S & P 500 Index average was $103 and the Dow Jones Industrial Average was $111.

The problem is that many total reward architectures reward short-term thinking—and that's just plain corrosive to organizations. Two groups—the Business Roundtable's Institute for Corporate Ethics and the CFA Institute's Centre for Financial Market Integrity—have put together a report that illustrates the effect of short-term thinking (7). In a nutshell, the report shows that companies focused on short-term earnings put long-term value creation by the wayside. Are there any solutions? The report has those too. It suggests eliminating earnings guidance and instead structuring pay plans to reward long-term strategic and value-creation goals instead of short-term stock market goals (8).

What happens when companies fix the mix so that it focuses on, say, quarterly earnings? The Enron scandal is a great example of how things can go awry when organizations become bedeviled by quarterly earnings. And Coca-Cola, under the late Roberto Goizueta, is another example of what happens when someone becomes obsessed with short-term financial results. If you remember back to when Goizueta was at the helm you'll remember that Coca-Cola always made its quarterly number, usually by a penny or so a share. But the gig played itself out when Goizueta died and it became apparent that a little magic number manipulation was used to get those numbers to come out just so. Was that good for investors? It sure wasn't, and Coca-Cola, though it has since gotten on the straight-and-narrow, is still paying for past sins today. Short-term focus is directly at odds with creating long-term value for the company—and ultimately for the shareholders.

If we haven't convinced you yet that a total reward architecture that rewards short-term thinking isn't good for anyone, consider this. You might want to sit down—it's a doozy. In a 2005 study conducted by three economists for the National Bureau of Economic Research, 400 executives were asked questions about the importance of quarterly earnings (9). They found out—and this shocked us—that just about 80 percent would decrease discretionary spending in major areas like advertising, maintenance, and research and development if that's what it took to make the quarterly numbers. Obviously, the typical reward architecture encourages executives to make decisions that are not good for the overall success of the organization.

Are we saying that boards and committees should check in with their executives every five years of so to see how they are doing? Of course not. Structuring your reward architecture so that it focuses on long-term value has its own problems, as we've all learned by now. So we aren't suggesting that you ignore short-term performance. No way. Rather, we're calling for a nice balance. Paying executives for achieving critical long-term strategic goals, while also including something in the mix that ensures short-term goals aren't forgotten, is something to consider.

The "Why" Dimension

The "messages" component of total reward architecture should answer the question "why?" The message component tells executives, through the reward system, what is expected of him. A well-articulated message allows executives to focus on business goals—it is where total reward strategies and the efforts of executives are aligned.

AQ1 Here's another way to think of the messages component. It is the philosophy behind the reward plan. It is, in effect, the reason *behind* a reward strategy. In a nutshell, it tells you what the plan is designed to accomplish.

What message do you want to send? It's not enough to say, in general, the goal of your total reward strategy is to "promote company success" or something equally as vague. Instead, based on the factors discussed in this book—

environmental and key stakeholder issues, vision, mission, and values, business and people strategies, and organizational structure—you'll decide what kind of messages best suit your organization. There are all different types of messages.

So what's the best message? The one that best suits your company. For example, a high-tech company that is introducing a new product and wants to be sure to get that product first to market might pay for short-term performance, while a pharmaceutical company that emphasizes research and development might pay for long-term performance. A company with a hierarchical organizational structure might send the message of pay for individual performance, while a company's whose success relies heavily on the sharing of information might send the message of pay for group or corporate performance.

But while there may be no best message, there are certainly ones that are more popular. Shareholder angst has more companies touting the pay for performance message, and indeed, companies from Coca-Cola to Google are making it known that they won't be paying money for nothing.

Other companies haven't quite clued in. Take Hewlett-Packard, which paid ousted CEO Carly Fiorina about $180 million during her five years at the company and a $21.6 million severance package despite a decidedly lackluster performance. Fiorina may not have done HP any good, but she'll still be livin' large much to shareholder chagrin. You would think the board and the compensation committee had learned from their mistakes, but no. New CEO Mark Hurd enjoyed the same kind of front-loaded non-performance-related package, complete with a $2 million signing bonus, $8.7 million in stock, and $5 million in price protection payments (10). What kind of message is HP sending? Certainly nothing along the lines of pay for performance. More like, "Don't worry, be happy."

But happy executives don't mean happy investors. A study done by the Corporate Library showed that front-loaded compensation plans hurt widespread efforts to link pay to performance, and certainly at no benefit to the offending companies. According to the study, over a 5-year period 11 companies listed as the worst offenders paid their CEOs a total of $865 million—but also experienced a $640 billion decline in shareholder value (11). If this isn't a good example of how people who should know better don't understand how incentive pay should work, then nothing is.

A study by Glass Lewis, in which they analyzed 2,375 companies, shows how the message component of the total reward architecture can make a big difference (12). Glass Lewis graded the companies based on shareholder wealth and business performance: changes in stock price, per-share earnings and book value over the two prior years, and total return, return on equity, and return on assets for the previous years.

What did Glass Lewis uncover? Check this out. Of the 25 worst companies whose message seemed to be payment for a pulse, chief executive pay averaged $16.7 million in 2005, while the stocks fell an average 14 percent and their overall net income dropped an average of 25 percent (13). On the other end were 25 companies that paid more modestly but had happy investors. CEOs at these companies earned an average of $4.4 million, but their companies' net income grew by 44 percent and their shareholders enjoyed one-year stock gains that averaged just about 40 percent (14). So there you have it. The right message will tell executives what is expected of them, and the compensation plan will be structured so that when they heed the message, they will be rewarded. It's as simple as that.

Now that we've explained how money, mix, and messages make up a total reward architecture, our next line of business is to discuss the components of a total reward strategy. We are going to show you how the mix of these components—base salary, short-term incentives, mid-term incentives, long-term incentives, wealth creation incentives, benefits, perquisites, and development rewards—can be leveraged to motivate executives to make decisions that bode well for the company and its investors. Again, there's no magic formula. The money, mix, and messages are unique—and put an organization's CEO in action.

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