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This paper was extracted from a presentation to the Yankee Chapter of YPO. The audience consisted of young presidents and their spouses. The nature of the topic, as well as an early-afternoon program slot, were important considerations in the selection of a very informal tone for the technical material. That informality has been retained in this condensation because it was a distinctive feature of the original presentation.

EXECUTIVE COMPENSATION

Executive compensation is a yeasty subject. I'll even suggest to you that tinkering around with executive comp can be riskier than mountain climbing or precision aerobatics. Don't mistake the nature of that risk. Lives may not literally be at stake; but careers can be on the line, as well as the stream of future corporate earnings.

At Haskins & Sells, we get many requests to review the executive-compensation plans of our clients. I suppose one reason for such interest is that most listed companies have executive incentives. Yet, I have concluded that a straight salary plan is about as effective as perhaps one out of every two bonus plans that I have reviewed.

There are many schools of thought on executive compensation. Some are inspirational; others are procedural. But executive compensation really deals with getting people to do the *very best* they can at a job they do every day. If we respond successfully to the challenge represented by executive compensation, our people remain no different in many ways from their counterparts in other organizations. Except for one thing. They've lost a human habit—the habit of *complacency*.

Another thing about executive comp: It can get technical—the selection of benchmarks, tax considerations and other such things. Listening to a tightly organized thirty- or forty-minute description of alternative executive compensation plans for a bonus company can turn *me* off. And it might turn you off, too! So, we won't do *that* today. Instead, as a starter, perhaps you would be interested in thinking along with me for a few minutes while I trace through a couple of the pulse points of executive comp. After that we'll review some sources of information on executive compensation. Next we will look a little more closely at the supplemental or incentive element of executive comp—and then, finally, reexamine some ideas about leadership.

Now for the pulse points. They have to do with what makes an executive comp plan *work*—whether or not the plan has, or should have, incentive features. The pulse points are: *the boss* and *the business.*

First, the boss:

- Is he willing to penalize as well as reward?
- Does he strongly prefer a comfortable business environment?
- Is he by temperament an initiative leader or a consensus leader?
- Will he believe in the "right" compensation plan?
- Will he really *make* it work?

Second, the business:

- What industry is it in?
- How good are its business-planning and profit-planning practices?
- How is it organized?
- Are individual positions ranked fairly in terms of their potential value to the company?
- What is the prevalent philosophy of compensation: above, below or equal to the average of the executive market place?
- What about the board of directors?

Let's get more specific. *The boss*:

- Can he create, or has he already created, an environment where, because of the structure of psychological and real rewards, the existing personal motivations of his people are also channeled toward performance for the business?
- And if an individual proves that he or she cannot perform in such an environment, will the boss replace that person with someone who can?
- Does that environment include specific targets that *require* management action in order to make things happen?
- Once such targets are set, will the boss take the time to see that they are achieved? (And such followup takes a fair bit of the boss's time.)

I'll have more to say about the boss a little later when we think about leadership. For now, let us get more specific about *the business*:

□ Is it likely that its industry environment is compatible with incentive plans?

□ Are there only a limited number of key decisions, and are they pretty much limited to a handful of top-management officers?

□ Do the key decisions have principally a long-term impact on the company's bottom line and tangible net worth?

□ Is the business one that operates well with a functional organization structure in which only the chief executive really has full profit responsibility?

If the answer to these questions is "yes," the business may not be a good prospect for executive incentives. On the other hand:

□ *If* the answers are "no"

□ *If* there are frequent key decisions made by people at several levels in the business

□ *If* the key decisions have a short-term punch

□ *If* the business operates best with a decentralized management structure *and*

□ *If* the business has available suitable quantitative benchmarks for judging executive performance

Then, the company probably is a good prospect for an executive compensation plan with bonus features—provided the boss *will* make the plan work.

SOURCES OF INFORMATION

Earlier I mentioned that there are a number of sources for information on salaries, bonuses and other forms of executive compensation. One comprehensive source is the Executive Compensation Service of the American Management Associations. Similar information is collected and published by The Conference Board, various industry associations and others. Proxy statements and 10-Ks also are good sources under certain circumstances.

There are two minor problems with published survey data. One is the time lag between the survey period and the publication of results, but the lag should present little difficulty once it is recognized. The other problem is that survey results tend to be broad averages and may require some interpretation and adjustment for use in a "nonaverage" company.

INGREDIENTS OF EXECUTIVE COMPENSATION

Now to comment for a few moments on a procedural approach to executive comp. We should look at three elements. They are, *first,* base salaries; *second,* supplemental and incentive compensation; and *third,* security factors such as pensions, life insurance, medical and savings plans. Each element is an important constituent of the compensation package, and the manner in which the three are combined determines structurally the overall usefulness of the entire plan.

We believe that salary is the keystone of the compensation arch. Pensions, insurance and the other components of the third or "security" element usually bear a direct relationship to the first element, base salary.

Now let's think about the second element, supplemental and/or incentive compensation:

□ The first step is to determine the extent to which the Board of Directors and the boss will *back* the plan, devote *time* to it and make it work. Assume that we have satisfied ourselves on those points.

□ The second step is to make up our minds whether or not we are operating in an industry that is *compatible* with incentive compensation. You will recall my earlier comments about that. Let's further assume that we have a winner there.

□ The third step is to formulate a statement outlining in general terms the objectives of the plan, who will be eligible to participate and how results will be measured. It's probably a pretty good assumption that a young company in a growth industry will have goals that are different from those of an established company in a mature industry. The benchmarks may be based on such things as:

Increases in sales or earnings

Return on investment or assets employed

Improvement in market share

Performance against budget

You may have noticed earlier that I used two words: *supplemental* and *incentive*. They are not synonymous; many businesses use supplemental and incentive types of compensation in unison.

□ *Supplemental* compensation plans, as we see them, are structured to provide additional income to the participants–usually a fairly broad group of middle management and top executives—whenever the Company's financial results are above a specified level that may be a relatively easy target.

□ *Incentive* compensation, on the other hand, implies that rewards are scaled more *specifically* to results and that the participants are those executives, and *only* those executives, whose responsibilities and actions can significantly influence the achievement of the specified results.

Some additional considerations in setting up an incentive plan are:

□ To achieve a balance between the recognition of current performance and those actions that are aimed at long-term performance

□ To eliminate the unintended inclusion of windfalls or other extraordinary unearned results

□ To take into account the characteristics of cyclical or high-risk industries wherein management performance may be good even in years with poor earnings

On the subject of taxes, we strongly advise that qualified tax counsel participate in developing and monitoring the incentive plan. Further, if the plan includes an incentive award for current performance, you may wish to give the participating executives some reasonable choice as to the form and the timing of payments. The individuals then would have the opportunity to plan their own tax strategy.

Another point is a policy question concerning incentives that involve the award of rights to stock or stock equivalents. The question is: Should executives be required to invest their own capital in the business? The use of phantom stock, phantom debentures and the like can produce for the executive and the business many of the advantages of direct investment, without an actual input of capital.

There is, indeed, a great fearsome flock of incentive plans that may warrant consideration. They can be classified by tax effect. They can be classified by type of plan. They can be classified in quite a number of ways. Therefore, I make to you the very practical suggestion that when you are nearing the time of decision, there should be considerable involvement of the directors and the tax officers of the business. A final point. In some circumstances, individual incentive awards might be more fairly determined on a subjective basis, man by man, rather than from some overall formula.

LEADERSHIP

Now let's move to the subject of leadership. I want you to do some hard thinking with me for the next few minutes. You may have noticed lately that the United States is struggling with some changes, first, in the principles concerning who obtains power and, second, in the standards of authenticity that support the way power is used. I suppose the distinguishing qualities that help a man in his quest for power sometimes can limit his effectiveness in using power.

And you, ladies and gentlemen, are in a very good position to know about the personality traits of the people who lead businesses. We can dramatize the differences in such leaders by admitting of only two opposite types—and clearly there are more than two in the real world. But the archetypes might be characterized as the *initiative leader* and the *consensus leader*.

The initiative leader is a person endowed with unusual qualities and with a kind of internal fire that directs and sanctions his actions—a person strongly propelled by his convictions and by his rather special perceptions of reality.

His opposite, the consensus leader, is a person who manages according to the prevailing, accepted customs for arriving at collective judgments. The consensus leader serves as the principal vehicle for crystallizing and ratifying the opinion of his subordinates, initiating a flow of initiatives by delegating authority.

The initiative leader is often disliked intensely in consensus environments because he is neither a particularly good delegator nor is he sufficiently patient to wait for initiatives from the established centers of corporate power.

With the consensus leader and his subordinates, procedure is important—how the game is played. With the initiative leader, it is winning; he just is not built to lose.

Earlier in this hour, I talked about the boss. I posed a question about the environment he creates. I asked whether he could penalize as well as reward. In business, you see, we can use planning, measurement and control processes to set targets and to measure performance. When the objectives and the performance of the profit centers and their leaders are highly visible, a decentralized management philosophy can work well with either kind of leader. But when goals are mushy and the reporting processes rusty, the loss of initiative by the boss can wipe out the business. In such circumstances the initiative leader may well be the kind of leader needed—so long as he *initiates*.

The initiative leader can be very effective when the business is attempting to survive in a hostile environment. But he can lose his effectiveness when the crisis passes, because he is difficult to control, resisting adaptation to the requirements of the more routine environment.

Probably you see where I am headed. I have talked about the challenge of executive comp—the challenge of getting people to do the very best they can at a job they do every day. I highlighted the pulse points of an executive compensation review—the *boss* and the *business*—and the most important element of success: commitment of the boss to the plan and his devotion to making it work. Now I am suggesting that the plan should be in harmony with the leadership style of the boss. And I am further defining the boss as the most powerful and influential person in the business—the nominal chief executive, the retired founder, the dominant member of the board—whoever he, or she, may be. That boss has the chance to help people lose the human habit of complacency—to do their best. That's how it is with challenges such as executive compensation. They require us to do our best, too.