FOURTH EDITION

THE COMPLETE GUIDE TO

EXECUTIVE COMPENSATION

FULLY REVISED AND EXPANDED EDITION OF THE CLASSIC BESTSELLER

BRUCE R. ELLIG

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BRUCE R. ELLIG

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Although I have made every attempt to be accurate and current, it is important to realize that this is not a book that professes to provide expert information on accounting, legal, SEC, tax, or other professional service matters. You need to seek appropriate professional counsel for such information. Statements, data, and other information made in this book are intended as illustrations that can help you frame such further investigations with the help of counsel. Nevertheless, the material in this book provides a good understanding of most executive compensation issues and will help you formulate good questions for those discussions.

—*Bruce Ellig*

This book is dedicated to my wife, Janice—lover, best friend, and soul mate.
In addition to all she does for me, she is the very successful owner
of her own executive search firm, The Ellig Group.

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Preface

This is the revised and expanded fourth edition of my book, somewhat immodestly titled *The Complete Guide to Executive Compensation,* for that was its objective from the beginning. It is preceded by the first edition (2002), the second edition (2007), and the third edition (2014). Each edition not only updated previous material but also expanded the material covered. As a result, each edition exceeded the previous edition in the number of pages: 2002 (598 pages), 2007 (793 pages), 2014 (1,004 pages). Because of over 500 illustrated figures and tables, as well as a glossary of over 2,000 definitions, this edition continues the expanded page count with 1,248 pages.

Why did I write this book? I wanted a book that I would use in designing the most effective executive compensation plan blending salary, benefits, and perquisites with short- and long-term incentive pay plans in the reward of performance. This is the reason for the immodest title *The Complete Guide to Executive Compensation* within the boundaries of FASB accounting rules, SEC regulations, and IRS interpretation of tax laws.

The basic premise of the book is that executive compensation should reward the person for thinking and acting like an owner, not simply an investor. The pay plan should reward outstanding performance and penalize poor performance.

The reader should also note that the book does not cover overseas compensation, per se, namely, various allowances and special perks; however, it is very common to include top executives working outside the United States in corporate short- and long-term incentive plans, and these are a major focus of the book.

You may want to begin by reading the last chapter, which summarizes the previous 11 chapters and provides an overview of what is covered. I was tempted to lead off with this summary of chapters but decided against forcing the book's sequence on the reader. Next, I suggest reading Chapter 1 because it provides an overview of executive compensation. Although the other chapters follow a sequential logic, it is not imperative they be read in the order shown. Some readers will have an interest in a particular chapter, such as long-term incentives or the board of directors; others might find it of interest to read through the entire book to gain a better appreciation of the makeup of executive compensation.

Although I have made every attempt to be accurate and current, it is important to realize that this is not a book that professes to provide expert information on accounting, legal, SEC, tax, or other professional service matters. For that, you need to seek appropriate counsel. Nevertheless, I believe the material in this book provides a good understanding of most executive compensation issues and will help you formulate good questions for those discussions.

Although I've made every attempt to avoid errors in this book, I regret if any exist. I am very interested in comments and suggestions that would make the next edition more useful and come closer to really being the "complete" guide to executive compensation it strives to be. Send these to me: BruceEllig.com.

And while Brucell and other proper names in the book are fictitious, some bear a striking similarity to members of the Ellig Family.

Acknowledgments

First and foremost, I want to thank several people without whom the book would never have happened. My first editor, Mary Glenn, for her initial support; Sandi Davidov, who was a significant contributor to all four editions of the book; Ingrid Fulmer, who was very helpful in the early stages of this fourth edition; Maria Matveeva, for her extensive research on virtually every portion of the book, as well as her superb word processing skills; William Steiger, who assisted on the legal issues; Davia Temin, for her outstanding guidance on marketing the book. And to Steve Straus of THINK Book Works, who guided the manuscript through various stages of production.

There were a number of people who were helpful in earlier editions, and they were listed in the first, second, and third editions.

Several people were very helpful to me early in my career, one that resulted in a strong passion for the field of compensation. They include the late Professor Alton Johnson, who got me interested in the field of compensation while at the University of Wisconsin; the late Bill Stuart, who hired me at Pfizer and lived the values of business partner and employee champion; the late Don Lum, who followed Stuart as Vice President, Personnel, and was my boss and big supporter while there; Chairman and CEO Ed Pratt, who gave me the top HR job at Pfizer (the third in the company's history) and made it enjoyable while demanding; President Gerry Laubach, without whose support I would not have gotten the job; and Bill Steere, who continued to make my job challenging and very rewarding before retiring.

Thank you all!

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CHAPTER 1

Executive Compensation Framework

As the title of this book suggests, this is a handbook or desktop reference tool on executive compensation. You can read it cover to cover, chapter by chapter, or access it selectively for definitions and examples of various programs. It is intended to be useful to several different audiences: designers, approvers, and administrators of executive pay delivery systems, along with those who write and report on executive pay, as well as executives themselves. Each group will understandably have a different degree of interest as well as different perspectives.

Executives, as the recipients of pay plans, will find this book useful both in describing what they don't have and for reviewing plans in which they participate. *Approvers* of executive pay plans will find not only valuable definitions and descriptions of various types of plans but also useful insights as to the conditions under which they might be used. Thus, this book offers independent input to complement that provided by the recommenders of the pay plan. Hopefully, *designers* and *administrators* will find details and examples that will trigger their own creativity; for those who *report* about executive pay plans, this book will not only provide useful background but also help form a better understanding of the topic.

Having defined how various readers will find the book useful, it is important to indicate what the book does not purport to do. Specifically, you should not rely on accounting, legal, Securities and Exchange Commission (SEC), tax, or other potentially legally binding statements in this book. Seek appropriate professional counsel for such guidance. The statements made in this book are offered as illustrations to help readers understand principles and practices. You should consult with appropriate counsel before making any binding decisions.

This chapter will define *executive, compensation*, and the *organization* in which the executive earns compensation.

THE EXECUTIVE

Who Is an Executive?

We can define executive by one of seven methods: corporate officer, job grade, job title, key position, reporting relationship, salary, or some combination of two or more of these methods.

Corporate Officer. This position is either appointed or elected. The former is appointed by the board of directors and responsibility is solely to attest to the corporate shield. The latter is elected by the board of directors and can bind the company legally.

Job Grade. The use of *job grade* to determine who is an executive—similar to salary—also has a misleading degree of precision. The rationale is simple: the value of a job to the organization was already determined when each job was placed in a job grade. The approach is superior to use of salary in that it relates to the job, not to the person's earnings. However, it places a similar pressure on the compensation program—pressure to upgrade positions into the eligible group.

Job Title. Eligible candidates could be determined by job title (e.g., vice presidents and above). The problem with this method is that the lowest-level vice president may have less responsibility than the highest-level director. It also raises the issue of organizational comparisons. For example, are divisional vice presidents as important as corporate vice presidents? Or even, are vice presidents in Division A as important as vice presidents in Division B? This might lead to a multitiered job title list as shown in Table 1.1.

Organizational Unit	Title
Corporate office	Vice president and up
Group	Executive vice president and up
Division	President

TABLE 1.1 Example Eligible Executive Titles by Organizational Unit

Key Position. Using the *key position* approach means examining each job for appropriateness (e.g., only those positions with "bottom-line" responsibility). Or it may be restricted to include only corporate officers or insiders as defined by the SEC. Administratively, this practice has two drawbacks. First, it is possible that two jobs in the same job grade will be treated differently. Second, it will be necessary to review the list of eligible candidates on almost an annual basis for appropriate additions and deletions. This approach is generally more prevalent among smaller organizations than among larger ones. When used, it normally results in staff jobs being included.

Reporting Relationship. Reporting relationships are used by some to determine who is an executive (e.g., the top three organization levels in the company). The problem is the inclusion of "executive assistants" and "assistants to" whose degree of importance to the position is better represented by their job grade than by their organization level.

Salary. Using salary to identify eligibility is fairly simple once the appropriate salary level is identified; however, it has several drawbacks. First, it gives a false degree of finiteness to eligibility—for example, $100,000 and up "yes" versus $99,999 and below "no." Second, considerable pressure will be exerted to move people above the magic cutoff. Third, the cutoff must be adjusted annually in relation to compensation adjustments; otherwise, the size of eligible candidates will continually increase.

Combinations. Because each of these seven approaches has one or more disadvantages or shortcomings, the best approach may be a combination of two or more definitions. For example, using the definition of anyone in grade X or higher within the top three levels of the organization takes pressure off job regrading and the need to include "assistants" and "assistants to."

How Many Are Executives?

For many, an executive is probably an individual in the highest paid 2 percent to 3 percent of the company's total employee population or in the highest paid 5 percent of the exempt portion of the workforce. However, these percentages are only rough guidelines. The percentages would probably be lower in centralized companies and higher in decentralized organizations. The terms refer to where decisions are made in the organization. In *centralized* companies, decisions are made at the very top of the organization. In *decentralized* companies, the ability to decide is pushed down in the organization. Within each type, the organization can be structured by function, such that each major activity (e.g., sales) has its own head reporting to the CEO, or it can be structured such that each unit represents a product or geographic area and the major functional areas are contained within each unit. As layers of management are added in the organization, decision making slows. The relative percentage of executives to the company's total employment is compared and contrasted with the size and type of organization in Table 1.2.

	COMPANY STRUCTURE	
Revenue Size	**Centralized**	**Decentralized**
Large	Low	Moderate
Small	Moderate	High

TABLE 1.2 Percentage of Executives to Total Employment Relative to Revenue and Structure

One might expect a higher percentage of executives in a capital-intensive rather than people-intensive organization because equipment, not people, dominates the lower levels of the organization. In people-intensive companies, decision making must be pushed further down in the organization; otherwise, the company will be a slow, plodding bureaucracy. For these reasons, capital-intensive organizations are likely to be centralized, whereas people-intensive organizations are likely to be decentralized.

Table 1.3 is a generalization contrasting the percentage of executives to total employment in centralized and decentralized capital-intensive and people-intensive organizations. As one would expect, the lowest percentage would be found in centralized, people-intensive organizations (i.e., large workforces but all major decisions made by a handful of executives at the top of the organization). Whereas a decentralized, people-intensive organization would have a moderate percentage of executives relative to total employment because executive decision makers would be at all levels, with a relatively small workforce. With a centralized, capital-intensive organization, there would be fewer executives and, therefore, a moderate ratio. With the move from a people-intensive to a capital-intensive organization, the number of executives decreases more slowly than the nonexecutive population does. The reverse is also true in moving from a capital-intensive to a people-intensive organization. This generalization will not apply in many situations because of the various definitions used for executives—some being more liberal than others. Nonetheless, capital-intensive versus people-intensive is a factor in determining the weighting of executives to nonexecutives in an organization.

	Capital-Intensive	**People-Intensive**
Centralized	Moderate	Low
Decentralized	High	Moderate

TABLE 1.3 Percentage of Executives in Centralized and Decentralized versus Capital-Intensive and People-Intensive Organizations

THE COMPENSATION

Extrinsic versus Intrinsic Compensation

It may be easier to think of pay as a form of extrinsic compensation, whereas work environment, type of work, learning, developmental opportunities, and extent of recognition form intrinsic compensation—often called psychic income. Other forms of intrinsic compensation include autonomy and power. Combined, extrinsic and intrinsic compensation constitute the total reward structure.

Organizations that are visibly successful may be providing some intrinsic compensation to their executives (i.e., a pride in membership). Since such organizations usually pay at least competitively, the intrinsic pay reinforces the retention capability of direct pay. Conversely, less successful organizations, which may be unable to afford fully competitive pay, place additional pressure on the pay package since intrinsic compensation may actually be low to negative and must be offset to retain the individual.

As shown in Figure 1.1, all jobs have a combination of intrinsic and extrinsic compensation. I believe that, to the extent the job does not have a desired level of intrinsic compensation, an offsetting level of extrinsic compensation is required. This could explain why garbage collectors earn almost as much pay as some college professors. No one will ever mistake garbage collecting for a job with high levels of intrinsic compensation. Conversely, the intrinsic appeal of being a college professor or a prominent politician (e.g., U.S. senator) explains why the extrinsic pay in these professions seems low as compared with other jobs.

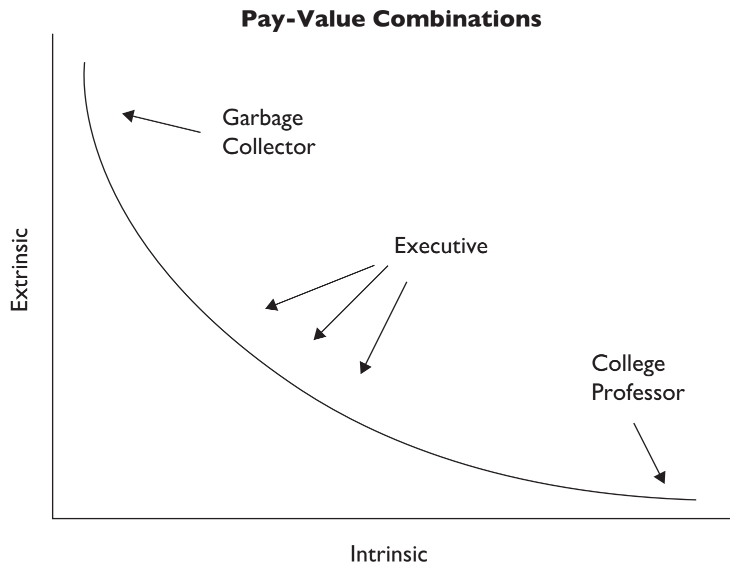

FIGURE 1.1 Extrinsic versus Intrinsic Pay

Executives are somewhere in the middle of the curve, either shedding intrinsic needs because of positive pay-performance situations (e.g., for-profit sector) or increasing searches for high intrinsic compensation because the direct pay-performance link is not sufficiently strong (e.g., nonprofit sector). In addition to seeking a position that has sufficient extrinsic compensation to meet ego and other needs, most are looking for work that is high in intrinsic compensation—personally meaningful and satisfying. Executives, more than others in the corporation, usually have sufficient flexibility in organizational issues to be able to organize their work, at least in part, to meet their intrinsic needs; however, their accountability may be in areas of low interest. The emphasis in this book is on extrinsic compensation, although even extrinsic pay has intrinsic aspects.

The Compensation Elements

There are five basic compensation elements: salary, employee benefits, short-term incentives, long-term incentives, and perquisites. As shown in Figure 1.2, only salary and employee benefits are a factor at the lower portion of most organizations; however, all five are present at the CEO level—each of the other three being phased in at different points in the organization.

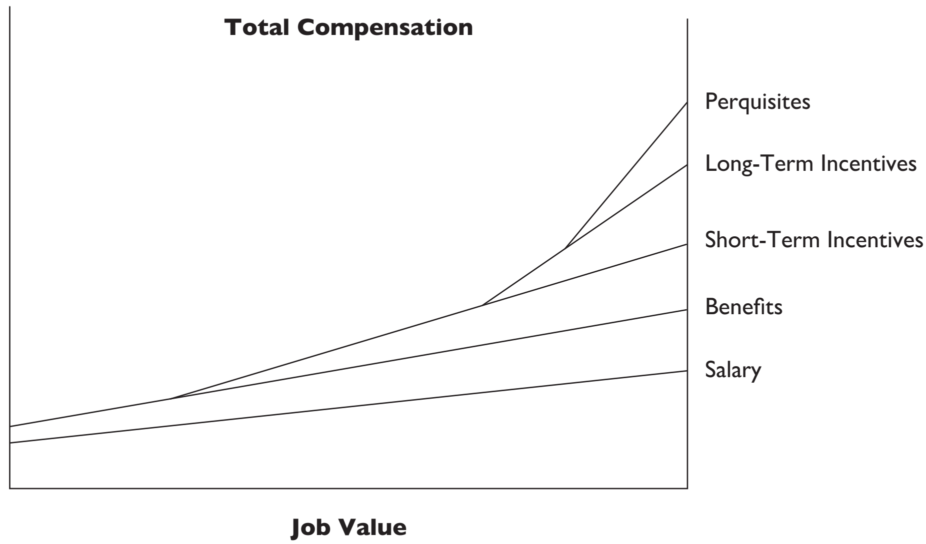

FIGURE 1.2 Total Compensation (five elements)

Salary. It is believed that the word *salary* is derived from the Latin word *sal* for "salt," a common form of barter and payment in ancient times. Salary is very important, as it is the base on which the other four compensation elements are structured.

The salary portion of the compensation program is normally determined by sequentially engaging job analysis, job evaluation, salary surveys, and pay guidelines for performance and promotions. The objective of the salary element (Chapter 5) is to reflect the extent of experience and sustained level of performance for a job of a particular level in importance to the organization. Many times it is also the basis on which the other four elements are determined.

Salary is the income level that will allow executives to meet some, but not all, of their lifestyle objectives. A more extensive and expensive lifestyle can be supported through the short- and long-term incentive plan payouts. The latter keeps the executive "at risk." Essentially, salary is a no-risk form of pay since it is rarely, if ever, reduced. However, since incentives are essentially nonexistent in some industries and in nonprofit organizations, the salary program takes on added importance in adequately reflecting short- and long-range contributions to the organization. When this is true, it is important that salary be competitive in the marketplace with annual cash compensation (i.e., salary plus annual incentives) at levels comparable to similar positions in other companies. However, the extent to which a company chooses to be directly competitive on salaries is a function of the degree of risk or reward it wants to build into its program.

Employee Benefits and Perquisites. The employee benefits (Chapter 6) element deals with providing time off with pay, employee services, awards (other than performance), healthcare, survivor protection, and retirement coverage to all employees in the organization. Cost effective to both the organization and the executive because of economies of large-scale coverage, employee benefits meet many needs executives otherwise would have to pay for from their own pockets. The extent of coverage is typically determined by years of service and/or level of pay. Since benefit coverage is rarely related to performance, it is not a viable incentive for inducing behavior modification.

Also covered in Chapter 6 are *perquisites*, namely, employee benefits that are designed only to apply to executives and, therefore, are also called *executive benefits*. In some instances, they merely supplement employee benefit coverage (often that limited by law); in other instances, they provide coverage that does not exist in the employee benefit program. Some executive benefits take the form of intrinsic or psychic income (e.g., a large, well-furnished office).

Perquisites are given to individuals based on organization level (and perhaps to some extent are viewed as symbols of authority); in other situations, they are rationalized as making the executive a more productive performer by delivering compensation in a more tax-effective manner. Like benefits, they have a low risk factor because degree of participation does not vary with performance. Once given, they are rarely taken away. Therefore, they do not lend themselves well to behavior modification. Their value to recipients is often more intrinsic than extrinsic in nature, although even most forms of intrinsic compensation have an extrinsic value to the taxing authorities. About the only thing they have not figured out how to tax to date is an impressive job title.

The most common perquisites are additional life insurance, additional vacation, company car, employment contract (with extensive severance pay), financial planning (both capital accumulated and tax minimization), and supplemental executive retirement plans (SERPs). The last one is of two types: restoration (replacing benefits curtailed by Section 415 of the Internal Revenue Code and therefore sometimes called Section 415 plans) and add-ons (which typically supplement short service for second-career executives).

Short-Term Incentives. Short-term incentives (Chapter 7) are designed to include both downside risk and upside potential, rewarding the extent of accomplishment of a short (normally, yearly) target. Typically, the amount of payment goes up and down each year in relation to performance, thereby lowering costs to the organization when performance is low while providing the executive an opportunity to attain significant rewards for achieving or exceeding objectives. An example of the degree of risk identified in the salary element above is shown in Figure 1.3. The more darkly shaded area represents the short-term incentive opportunity. As risk increases, salary (the less-shaded area) decreases, but it is more than proportionately replaced by incentive opportunities.

Although executives typically like the high-risk, high-reward model, it is important that boards and compensation committees not build in so much risk that it could affect the company's solvency or, even worse, that of the entire country. One only has to look at the subprime mortgage situation of several years ago to see what can happen if a very high pay package is based on an environment of very high risks. Both probability and severity need to be examined. The worst scenario is high probability combined with high risk, but even low probability with high risk must be carefully considered in plan design. Avoiding incentive payment for excessive probability rule is the key.

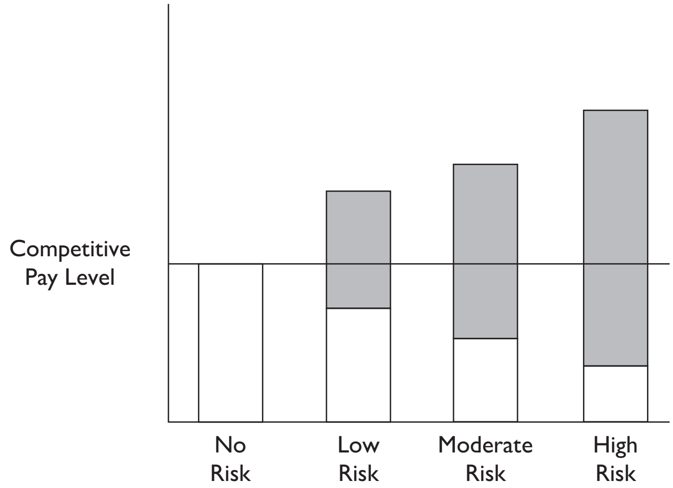

FIGURE 1.3 Risk-Reward Relationship

Objectives may be group or individual in nature and should be tied to annual business targets in a way that provides clear line of sight (i.e., one should not have to look around corners in an attempt to see the connection). Financial results are typically major components of short-term plans. Incentive pay increases as a percentage of salary as salary increases, thereby providing ascending reward opportunities. Some identify this as the *progressivity principle*.

Short-term incentive plans range from highly individualistic rewards for individual accomplishments to sophisticated profit-sharing plans that emphasize corporate, group, or division performance with little variation for individual recognition. The main drawback of the last type is that they will overpay the marginal performer in good years and underpay the outstanding performer in poor years.

Common financial measurements used in short-term plans include economic profit (after-tax operating income minus the cost of capital), earnings per share (net income divided by total number of shares outstanding), return on assets (net income divided by total assets), return on equity (net income divided by shareholder equity), and cash flow (the change in amount of cash for the period).

Representative nonfinancial measurements are customer and employee satisfaction (using questionnaires and interviews), new products (percentage of sales or income represented by products introduced in the last year or two), productivity (measured in terms of cost, quantity, and quality), and workplace issues (e.g., diversity, work-life balance, and image).

Additional financial and nonfinancial measurements are found in Chapter 2 ("Performance Measurements and Standards").

Payments are typically in cash, although some plans pay a combination of cash and shares of stock.

Long-Term Incentives. This element (Chapter 8) is similar to short-term incentives in objective, except that the performance period is multiyear in nature (typically 3 to 10 years). Normally, there is no individual performance component in long-term incentives, only some definition of group. The incentive award (which is typically significantly larger than the annual incentive) by definition means the executive has a portion of pay placed "at risk" with degree of attainment of business objectives. Not meeting the expected target calls for no payment or a low payment—a form of punishment short of termination of employment. The multiyear nature of long-term incentives provides some holding power over the executive if the payout will be significant later on. The progressivity principle defined in short-term incentives also applies here. Pay is typically based on shareholder value or on the financial performance of the defined unit (e.g., company, sector, or division), or both.

The importance of understanding the degree of risk included in the long-term incentive plan is the same as that described in short-term incentives. Only the measurement period is different.

Some argue that there are midterm plans (e.g., two to five years, such as restricted stock and performance share or unit plans) as well as long-term plans (e.g., more than five years, such as stock options). Most will simply state that anything multiyear in nature is a long-term plan.

The forms of long-term incentives are expressed in terms of those dependent on stock price and those independent of market value stock price. The multiyear nature of these plans creates a problem in predicting performance years in the future. The difficulty of setting such targets is a function of the degree of cyclical fluctuations within the particular industry. In some plans, action is needed to adjust individual payments; in all plans, it is a requirement for setting future targets—even the stock option grant requires some assumptions about future value.

Form of payment follows the type of plan. All market value stock plans are typically paid in shares of stock. All other plans are cash plans and are typically paid in cash (and, in some instances, shares of stock).

Unreasonable Compensation. The issue is who considers it "unreasonable"? The possibilities include the business press, shareholder advisory services, shareholders, the Internal Revenue Service (IRS), and other parts of the federal government. These are arrayed in ascending order of significance. The business press will state their position in their papers and magazines. The advisory services will indicate whether shareholders should vote yes or no on binding and nonbinding resolutions. And the IRS will determine whether or not to disallow tax deductions for amounts considered excessive. Other parts of the federal government (typically the president of the United States and members of Congress) whose actions range from the "bully pulpit" to laws and regulations can have a significant impact on executive pay.

While attacking CEO pay, few point out that private-equity and hedge-fund managers often make 50 times as much as the $10 million CEO, and, furthermore, their income is typically taxed at favorable long-term capital gains tax rates.

High levels of pay should only be accompanied by a high level of performance. This means the identification of appropriate performance objectives and the metrics to measure performance.

Although it is appropriate to consider the total of the five compensation elements in determining whether or not pay is excessive, the analysis usually does not include employee benefits, as they apply to all employees in the organization. And special attention is given to incentive pay, especially stock options. Few realize that the amount reported in a company proxy statement and the press for stock options is an accounting charge required by the Financial Accounting Standards Board (FASB). It is the present value of the grant using a formula such as Black-Scholes. It is not income actually received by the person. For that, one must look to income received from grants exercised. This subject is discussed in Chapter 10.

Unless there is a shift to paying for the building and sustaining of long-term shareholder value rather than revenue generation, CEOs and other top executives will be paid for the wrong reason and in the wrong way, namely, short-term rather than long-term incentives.

Relative Importance of the Elements

As depicted in Figure 1.2, but perhaps more clearly in Table 1.4, these elements of compensation take on different emphases at different pay levels in the organization.

	TOTAL COMPENSATION				
Element	**$100,000**	**$250,000**	**$500,000**	**$1,000,000**	**$5,000,000**
Salary	75.0%	55.0%	40.0%	30.0%	20.0%
Employee benefits	15.0%	11.0%	8.0%	6.0%	4.0%
Perquisites	–	1.0%	2.0%	4.0%	6.0%
Short-term incentives	8.0%	13.0%	16.0%	18.0%	20.0%
Long-term incentives	2.0%	20.0%	34.0%	42.0%	50.0%
Total	**100.0%**	**100.0%**	**100.0%**	**100.0%**	**100.0%**

TABLE 1.4 Possible Compensation Distribution (Total Pay = 100%)

For example, salary might be 75 percent of total compensation at the $100,000 level but only 20 percent at the $5 million level. Conversely, long-term incentives might only be 2 percent at $100,000 total pay but 50 percent at the $5 million level. Table 1.5 converts these percentages to dollars. Thus, at the $500,000 total-pay level, the 40 percent salary shown in Table 1.4 reflects $200,000 as reported in Table 1.5.

	TOTAL COMPENSATION				
Element	**$100,000**	**$250,000**	**$500,000**	**$1,000,000**	**$5,000,000**
Salary	$75,000	$137,500	$200,000	$300,000	$1,000,000
Employee benefits	$15,000	$27,500	$40,000	$60,000	$200,000
Perquisites	–	$2,500	$10,000	$40,000	$300,000
Short-term incentives	$8,000	$32,500	$80,000	$180,000	$1,000,000
Long-term incentives	$2,000	$50,000	$170,000	$420,000	$2,500,000
Total	**$100,000**	**$250,000**	**$500,000**	**$1,000,000**	**$5,000,000**

TABLE 1.5 Possible Compensation Distribution in Dollars

At higher levels of total compensation, decreasing emphasis is applied to salary and benefits, whereas an increasing emphasis is given to short-term incentives, long-term incentives, and perquisites. The reason for the decreasing emphasis on salary at the expense of short- and long-term incentives is that it is more advantageous to the company to relate reward to performance, and, in some cases, it is more advantageous to the individual to receive the reward in a form other than cash.

The limitations imposed in many benefit plans (e.g., maximum pension) and in the non-income-related programs (e.g., medical and dental insurance) account for the decrease in benefits as a percentage of total compensation as that figure grows. In many situations, however, this decrease is offset by perquisites (e.g., additional life insurance, chauffeured car, extensive vacations, financial counseling, and supplementary pensions).

One further variation of the relationship is shown in Table 1.6. There all elements are expressed as a percentage of salary. Employee benefits are often expressed as a percentage of salary, that is, 20 percent; however, this is frequently misleading, especially at the executive level. This is because short-term incentives are often included in the definition of pay for determining benefit coverage. This point is illustrated in Table 1.7, where employee benefits as a percentage of salary are constant as pay increases, but when expressed as percentage of salary plus short-term incentives, benefits decline. However, when perquisites are added to benefits, the downward trend is reversed. In this example, there is a very heavy emphasis on the perquisite, or executive benefit, package.

	TOTAL COMPENSATION				
Element	**$100,000**	**$250,000**	**$500,000**	**$1,000,000**	**$5,000,000**
Salary	100%	100%	100%	100%	100%
Employee benefits	20.0%	20.0%	20.0%	20.0%	20.0%
Perquisites	–	1.8%	5.0%	13.3%	30.0%
Short-term incentives	10.7%	23.6%	40.0%	60.0%	100.0%
Long-term incentives	2.7%	36.4%	85.0%	140.0%	250.0%
Total	**133.4%**	**181.8%**	**250%**	**333.3%**	**500%**

TABLE 1.6 Percentage Relationship of Elements to Salary

	TOTAL COMPENSATION				
Element	**$100,000**	**$250,000**	**$500,000**	**$1,000,000**	**$5,000,000**
Salary	$75,000	$137,500	$200,000	$300,000	$1,000,000
Short-term incentives	$8,000	$32,500	$80,000	$180,000	$1,000,000
Total	$83,000	$170,000	$280,000	$480,000	$2,000,000
Employee benefits	$15,000	$27,500	$40,000	$60,000	$200,000
% of total	18.1%	16.2%	14.3%	12.5%	10.0%
% of salary	20.0%	20.0%	20.0%	20.0%	20.0%
Benefits and perquisites	$15,000	$30,000	$50,000	$100,000	$500,000
% of total	18.1%	17.6%	17.9%	20.8%	25.0%
% of salary	20.0%	21.8%	25.0%	33.3%	50.0%

TABLE 1.7 Employee Benefits in Relation to Salary and Short-Term Incentives

The relative importance of each element at the different income levels would, of course, vary from industry to industry and even within a given industry from company to company. It will also be different for privately held companies and nonprofits.

External Market versus Internal Equity. A major consideration in structuring the pay package is the importance of the external market versus internal equity. This is especially important in determining the level of pay, not simply the form of payment. Internal equity is typically based on some form of job evaluation. Such plans are described in some detail in Chapter 5 ("Salary"). From such evaluations, an internal hierarchy is established. To determine the appropriate level of pay of each job, surveys are made of the marketplace and what other companies are paying. But what does a company do when it finds that a surveyed job is paid more in the marketplace than as suggested by the internal evaluation? If it is ignored, turnover may result and it may be difficult to recruit a replacement. If pay is set to reflect the market, it will place the job above the internal ranking. Many companies address this by reflecting the market in the determination and stating that it is an anomaly that cannot be used as a benchmark for other internal evaluations. To clearly indicate this difference, it may be called a "red-circled" job.

The pay relationship is especially important in the pay (as salary plus incentives) to top executives. More especially, if the gap or difference in pay between the CEO and the next-highest paid is too great, it may send a signal of relative importance that is inappropriate. Perhaps a multiple of five (e.g., $25 million versus $5 million) may be justified, but a multiple of two or three may be more appropriate.

Some companies look at the "cost of managing the company," namely, the total pay of the named executives in the proxy and then the percentage for the five or six named. If there are five, 20 percent would be the mean perhaps with 50 percent for the CEO and 5 percent for the lowest paid, with perhaps the second highest at 25 percent (thus a gap or multiple of two—50 versus 25) and the others at 12.5 percent and 7.5 percent. Looking at the top people in this manner of pay multiples is another test of the appropriateness of pay levels for the top executives. Comparing own company data with comparable companies is often informative.

Compensation Design Considerations

Factors that affect the design of the pay program are illustrated in Figure 1.4.

We have already highlighted the seven *compensation elements*, indicating where they will be reviewed in more detail: salary (Chapter 5), employee benefits and perquisites (Chapter 6), short-term incentives (Chapter 7), and long-term incentives (Chapter 8). The *performance measurements and standards* that can be used in the design of the executive pay program are reviewed (Chapter 2). Also included is a write-up on *current versus deferred compensation* (Chapter 3).

Next, we have the *stakeholders* and *rulemakers*. The stakeholders consist of the executives, other employees, shareholders, customers, suppliers, and the community. Within the community are the rulemakers, who limit the design and amount of pay. In the United States, at the federal level, they are Congress, FASB, the IRS, and the SEC. The stakeholders and rulemakers are covered in more detail in Chapter 4.

There we have the *board of directors* (and its compensation committee); they are expected not only to be shareholders but also to act on behalf of the shareholders. The board and the compensation committee are discussed in Chapter 10. They are responsible for approving the specifics of the executive pay package.

That leaves us to review *market lifecycle*, *type of company*, *structure organizational change*, and *strategic thinking* within the context of the organization—the place where the executive earns compensation.

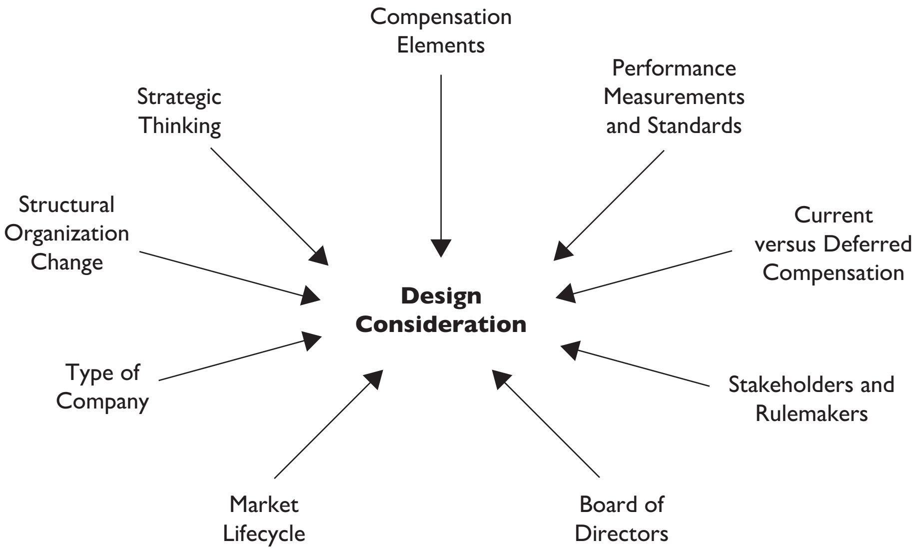

FIGURE 1.4 Compensation Design Considerations

THE ORGANIZATION

Type of Company

There are a number of ways to describe an organization, namely, publicly traded versus privately held, for-profit versus not-for-profit, or new economy versus old economy.

For-Profit versus Not-for-Profit Companies. For-profits are companies formed to make a profit, on which they will be taxed. Under certain conditions, executives may be personally liable for the acts of the corporation; however, for the shareholders, financial liability is limited to the funds invested in the company stock. The corporate tax rate may be higher or lower than an individual personal income tax rate, depending on level of income and most recent tax law.

Unlike for-profits that incur a loss, there are companies that are formed deliberately to not show a profit in order to receive favorable tax treatment; they must meet the requirements specified in the Internal Revenue Code to qualify. Although nonprofits do not intend to make money, they will get a lot of attention from the IRS if they show a significant residue left after paying all their expenses. Lacking a profit incentive removes many of the incentive opportunities (both short term and long term) available to the for-profits.

Subject to some exceptions, executives in nonprofits may be exempt from personal liability, with creditors entitled only to assets of the corporation. The inability to issue stock or pay dividends limits the choices available in executive pay planning to heavy use of benefits and perquisites.

Privately Held versus Publicly Held Companies. Publicly traded companies are those that are required by the Securities Exchange Act of 1934 to register their issues because of an offering to the public, as described in the Securities Act of 1933.

Publicly traded companies have shareholders who have the right to vote on both binding and nonbinding resolutions. Binding resolutions are those presented by the company and the shareholders that are subject to approval by the SEC for voting at the company's annual meeting. The most significant nonbinding resolution is that required by the 2010 Dodd-Frank Act on shareholder agreement with the executive pay and change of control contracts of the named executive officers. Although a negative vote does not require company action, it would behoove the company to make some adjustments or at least better explain its actions.

A company not meeting these act requirements is considered to be a private (or privately held) company. Where much of the stock is in the hands of a few, it is considered to be *a closely held private company*. The best example of a closely held private company is the *sole proprietorship*, in which the company is owned by one person. This form is common for small companies and rare for large organizations. Because the individual and the company are the same, the profits are taxed to the owner as personal income. When two or more individuals form a business and agree to be personally liable for the debts of the business and share in the profits, the business is a *general partnership*. When limits are set on the role of the partners and their liability for the debts of the business, the business is a *limited partnership*.

Subchapter S (Section 1361 of the Internal Revenue Code) is a version of a small, privately held company. Here, the stockholders are taxed on the company's earnings proportionate to the percentage of stock they own. This avoids the double taxation of dividends of other corporations.

Another type of closely held company is the *limited liability company* (LLC), which is a combination corporation-partnership. LLC members are taxed like members of partnerships, with income subject to income, Medicare, and social security taxes. However, unlike in a partnership, personal assets are not at risk when the LLC is deemed liable.

Being privately held is sometimes so attractive that a large shareholder of a publicly traded company proposes to take the company private by buying out the stock held by others. Since the individual wishes to do so at the lowest possible cost, such plans frequently result in lawsuits by other shareholders wanting a better price for their stock.

Two other versions of privately held companies are cooperatives (co-ops) and mutual organizations. A *co-op* is a company owned by its customers or suppliers, such as one selling agricultural products. A *mutual* is another example of an organization owned by its customers, such as one selling life insurance.

One might expect privately held companies to pay higher salaries than their public counterparts because of the absence of publicly traded stock and capital gains opportunities. However, this is far from a general rule—the reverse may even be true. Short-term incentives for both are very comparable using both internal and external measurements, although privately held companies may use fewer of the latter. Long-term incentives are similar in design, but the absence of a public stock market restricts the attractiveness of equity issues in private companies. Owners not wishing to diffuse ownership are another reason for limited use. Shares are typically subject to a buyback requirement stipulating that they must be offered for sale to the company (or named major shareholder) before selling or otherwise transferring ownership to someone else. This would occur at the time of leaving the company, disability, death, or other completion of a period of employment. These situations require the company to periodically arrange for an impartial appraiser to value the stock.

Private equity firms buy shares in privately held companies in the hope of selling them at a higher price later on, when the company becomes a publicly held company. Investments could be in small startups or well-established companies in the mature (if not the decline) stage of development. These investors began as the investment arms of well-established wealthy families, such as the Rockefellers; evolved into the hostile takeover investors of the 1980s; and now include company-initiated methods of raising capital.

There is a significant difference between individuals/organizations that invest in startups hoping to make a significant profit if the company does an initial public offering (IPO) and gets into the growth stage and those private equity firms that buy companies in trouble typically in the mature phase, cut costs including staffing, and, when the financial picture has improved, sell it or put it on the market as an IPO.

Unlike those in publicly traded companies, executives hired by private equity firms typically receive lower salaries but much greater incentive pay opportunities. Typically, these are in the form of stock options and/or performance shares tied to formidable goals and expectations. For this opportunity, the executive is required to invest significant money upon joining in addition to amounts from salary and incentive pay. Such arrangements typically are for a limited period of time such as five years. Since much of the incentive payment is tied to liquidating the company, the executive is prevented from cashing in before the liquidation date. The risk-reward relationship is much more significant in private equity firms than in publicly traded companies. Typically, general managers in private equity firms receive 1–2 percent of the company's capital and then 20 percent of the increase value.

Although private equity executives can do very well, few can compete with successful *hedge fund managers,* who may be paid in billions, not millions. This is possible if they receive an annual management of asset fee of 2 percent along with 20 percent of the annual profits. But given the number of hedge funds that periodically disappear, it could be argued that their risk is also significantly greater.

Both private and public companies vary not only by type of industry but also by the extent to which the industry is or is not heavily regulated. Where it is heavily regulated, pay programs (especially incentive pay plans) are likely to be subjected to a close review by the regulatory body before they can be implemented. This, of course, changes dramatically when the industry is deregulated.

Tables 1.4 through 1.7 identify the relative importance of each compensation element in a for-profit, publicly held organization not subject to close regulatory review. However, as suggested earlier, these values would not be appropriate for either a privately held or a not-for-profit organization. Neither has stock traded on a major exchange, thereby dramatically affecting the incentive plan programs. Furthermore, not-for-profits have to be very careful in structuring an incentive plan to ensure there is no undue emphasis on net asset change (i.e., the remainder after expenses have been subtracted from revenue, or what for-profits would call *profit*). The three types of organizations are contrasted during the growth phase in Table 1.8. Note the reversed positions in privately held and publicly traded companies in incentive types because common stock is not available to the privately held company. And for the not-for-profits, the absence of long-term incentives places more emphasis on salary and perquisites. If the privately held company chose to develop a phantom stock plan based on internal measurements, it might more closely mirror the publicly held company's mix in the growth phase, although it is unlikely that the premium the stock market would place on the stock could be matched with an internal plan.

	FOR-PROFIT		
Compensation Element	**Publicly Traded**	**Privately Held**	**Not-for-Profit**
Salary	Moderate	Moderate	High
Employee benefits	Moderate	Moderate	Moderate
Perquisites	Low	Moderate	High
Short-term incentives	Moderate	High	Moderate
Long-term incentives	High	Moderate	–

TABLE 1.8 Compensation Elements by Type of Company in Growth Phase

Not included in this analysis is the public sector, which, in many cases, has less emphasis on the pay elements than even the not-for-profits because of the scrutiny of the voter. Typically, salaries are low and short- and long-term incentives are nonexistent. Employee benefits are pretty good but probably not more than moderate in importance because of the shortness of service. How many make a career as mayor or governor, much less as president due to term limits? Perquisites are definitely high—both extrinsic and intrinsic forms.

Market Lifecycle

The Stages. There are four stages in the market lifecycle: threshold (startup), growth (dramatic increase in market share), maturity (plateauing of market share), and decline (falling market share). They are shown in Figure 1.5 in relation to sales or income. It should be recognized that the period of time of each is not a constant. Some products never get out of the threshold stage, abandoned because of failure to attract customers. Others will go through all four phases in several months; others will take decades. The ideal situation is to be in the growth stage the longest, for it is the most profitable stage.

Net income (i.e., profit) has a similar but slightly different profile than revenue (i.e., sales). As shown in Figure 1.6, most of the threshold stage may operate a net loss in profits. When a company enters profitability in the growth stage, profit begins to increase but perhaps not as rapidly as revenue because of increased expense to invest in the product (and provide an appropriate pay and benefits package for the employees). However, net income continues to increase at an increasing rate in the mature stage even as revenue is flattening because investments are being pared back and costs are being curtailed. This will continue into the decline stage until the fall in sales cannot be offset by cost containment.

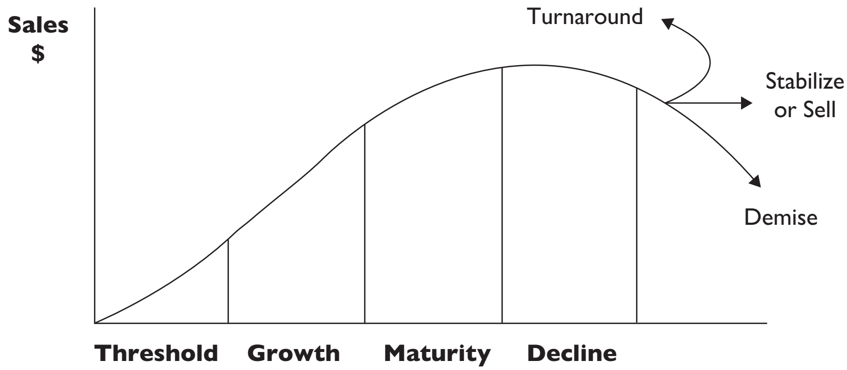

FIGURE 1.5 Four-Stage Market Cycle

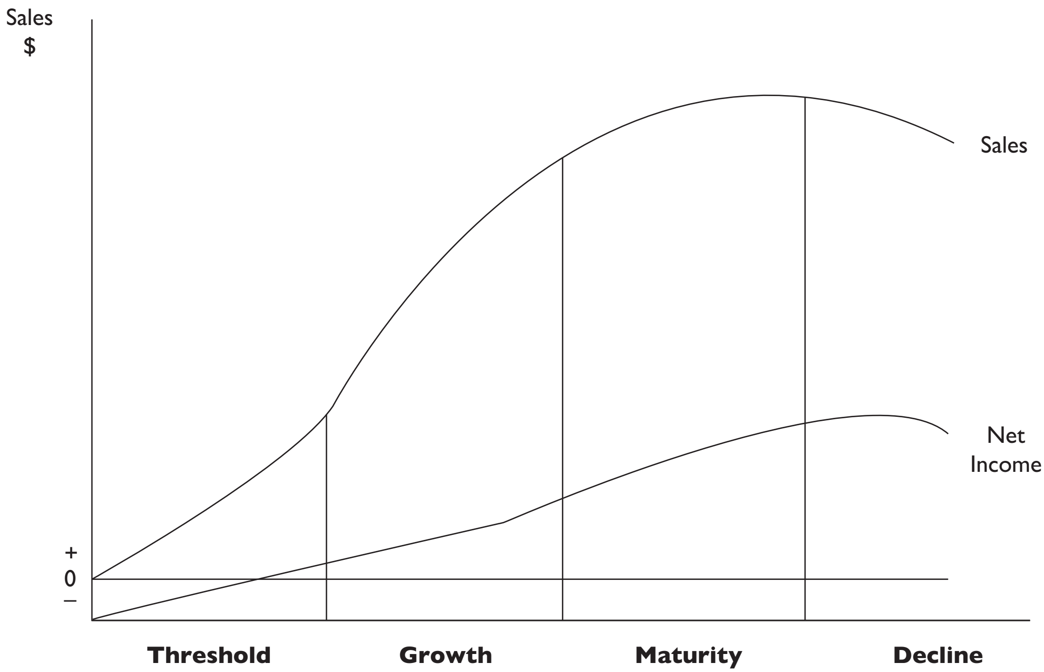

FIGURE 1.6 Sales and Net Income by Market Stage

The market cycle for a company is simply a consolidation of its products and where they are in their respective market cycles. By the same logic, a company or industry can be described by stage of lifecycle. Recognize that a product could be in the growth phase, where as the market for such products is in decline. Shown in Table 1.9 are the 16 possible combinations of a product's lifecycle versus the lifecycle of the market for the product. Indicated for each combination are possible actions.

COMPANY PRODUCT LIFECYCLE STAGE	THRESHOLD	GROWTH	MATURITY	DECLINE
Market for Product	**Company Action**			
Threshold	Risky	Invest cautiously	Maintain position	Look for change
Growth	Invest heavily	Stay the course	Increase market share	Hold market share
Maturity	Look elsewhere	Increase market share	Look for second wave	Milk it
Decline	Why bother?	Watch margins	Milk it	Milk it

TABLE 1.9 Product versus Market Cycle Position

By aggregating the products for a company particular to an industry, one can come up with a similar analysis. Contrast a company in the growth phase but in a declining industry with one in a maturity phase in a growth market. The first will quickly find itself in maturity or even decline unless it grows faster than the market declines. The other company finds that its revenues are increasing simply by retaining market share in a dramatically increased market. However, mergers, acquisitions, and divestitures can significantly alter where the organization is positioned on the market lifecycle, as will be reviewed later in this chapter.

Given the difference between company and industry in terms of stage in market cycle, more emphasis should be placed on industry. Thus, if the company is in the maturity phase whereas the industry is in the growth stage, the latter should be the primary reference since the company should be able to realize new crests (because of established market position) as the industry reaches maturity. Conversely, if the company is in the growth stage and the industry is in the maturity phase, it will be more difficult for the company to improve its current level of success.

An organization often consists of strategic business units (SBUs) in different stages of the market lifecycle. Thus, although the company may be categorized as the composite of its SBUs, it is important to remember each has different characteristics and needs and should not be smothered by an overarching corporate pay plan that is not in sync with different market stages. This argues for both corporate and SBU pay plans. Each needs to be reviewed annually and quickly adjusted as necessary. Ongoing review is likely to result in minor modification, reducing the likelihood of radical changes necessitated by ignoring the plan for too long. Let us examine the characteristics of each stage in the market cycle and what they suggest regarding programs.

Threshold. The threshold stage is the stage where the dream becomes a reality. The idea is transformed into a product or service and brought to the market. The idea may have been that of the dreamer, but it is the entrepreneur who capitalizes on it. The dreamer and entrepreneur may be the same or different individuals.

Before entering the market with a product or service, the company should carefully examine its potential. Who will be interested in buying it? How much are they willing to pay?

What is the competition? When are competing products likely to enter the market? Where will it be sold? Why is it expected to be profitable? What are the capital and other requirements to bring the product to market? What resources must be committed? When? How big is the market? What is the projected market share? The market is in what stage in the market cycle? What is its likely lifecycle span?

The long-standing belief is that the first product to enter a market has a major advantage over those that follow. But the market must accept (and buy) its product for the company to be successful. If the market fails to do so, a competitor will follow and attempt to convince the customer that it provides a superior product, be it in terms of price, quality, or service. If the competitor is successful, the pioneer will likely fail. Innovation without customer acceptance is a recipe for financial failure.

During the threshold stage, the company probably has a limited range of closely related products. Distribution of these products may be primarily in a regional area, the company may have attained a position of dominance in a small industry, sales are probably under $50 million, and managers are exploring new markets for products.

Decisions are made by individuals, often with little thought or delay and usually on intuition, as there are few, if any, policies and procedures. Written job descriptions and organization charts do not exist, and relative duties and responsibilities of individuals have not been clearly identified. A high degree of overlap in apparent responsibilities exists among a number of jobs. There is no depth of management.

The tone is casual, with everyone on a first-name basis, and the dress code emphasizes comfort rather than appearance. Survival of the products has the full attention of everyone. Cash is scarce and cash flow problems periodically occur, with management often deferring its own salary payments to ease the crunch and even maxing out credit cards. It is a time of high risk in order to survive. Increased sales and sufficient cash flow to meet needs are key.

The same would describe other companies in a threshold market stage. There would likely be many small companies with very specialized product brands marketed in small geographic areas.

Growth. The growth phase marks the period of tremendous growth as the threshold company emerges with strong success in new venture areas as well as becomes a national influence by challenging established leaders in market share. The shift is from product development to marketing maximization. In addition to maximizing revenue on the product or products introduced in the threshold stage, the company is expanding the product line into new markets, capitalizing on the brand name and its manufacturing, marketing, and distribution strengths. An increase in product lines probably has increased the diversity and complexity of related management processes. The number of employees increases along with sales, and management may shift from the original owners into the hands of professional managers, as the company must cope with different problems brought on by apparent success. Coordination needs are greater and communication more formalized to ensure consistent interpretation; relative priorities need major review to ensure optimal success. Return on shareholder equity is very strong and increasing significantly during this phase.

During this period, the company is likely to state its nature of business too broadly, venturing into product lines for which it lacks expertise. This often results in a level of performance far short of expectations; however, success in main lines overcompensates.

Cash and available time both seem to be in short supply as full energy is directed to maximizing product success and reinvesting in the business. Rapid growth places a major strain on the business because it can rapidly outgrow its production capability. Because of the shift in emphasis from getting the business started to keeping up with its growth, many startup executives decide to leave. Little time exists for formalizing job descriptions, although individual responsibilities are better understood as greater specialization is required. Written policies and procedures start to emerge. The depth of management is very thin; however, some replacements and new positions can be staffed internally by juggling. Decision making has become more formalized (and therefore slower), and alternatives are viewed in light of precedents set during the threshold stage. White shirts, rolled up at the sleeves, have replaced sport shirts; however, the tone is still informal and essentially on a first-name basis.

To stay in the growth phase, the company must continually find new uses for existing products or introduce new products, or both. This requires a careful analysis of available capital for manufacturing and marketing to optimize return on investment. Innovation without successful marketing leads to failure. Recognize that customers are making choices while the company is making plans.

The longer the company can sustain a competitive advantage, the longer it will stay in the growth stage. A favorable price based on control over costs may be a significant factor.

A market described as being in the growth stage would find an increasing number of large companies with a national focus that have established entry barriers that make it difficult for others to enter the market. An example of such a barrier would be a strong brand name. Building brand loyalty is critically important, and meeting customer expectation is key to gaining a competitive advantage. And it is important to realize that the marketplace is not static. Competitors are always making adjustments in response to the company's actions.

Maturity. The maturity phase is marked by little change in market position (some slippage may be offset by new products—mainly interpolation or minor extrapolation of existing products by product extensions rather than new breakthroughs). Emphasis is probably on maintaining current market penetration and servicing existing customers rather than on adding new customers. Market share is more likely to be gained by lowering prices than by increasing investment. Administrative expenses become an increasing percentage of total costs as productivity improvements chip away at direct expenses. Improvement in all areas is critically important. However, staff functions are increasing faster than the reductions in direct labor. Reducing costs is important, especially if sales revenues have flattened out; however, cash flow (because of various deductions) may be stronger than ever.

Job descriptions and organization charts have appeared, as have management succession charts to ensure adequate depth of management to meet organization needs. Corporate policies have been written to cover the full gamut of business issues, and an extensive financial record-keeping system has been developed. Managers find their freedom to act restrained by both. Due to policy limitations or dollar ceilings, the manager must now recommend rather than decide. Such recommendations require considerable time to prepare and justify. Committees have become popular during this phase and are often part of the decision-making process, resulting in both a slowdown of this process and a diffusing of individual responsibility. Transactional rather than transformational behavior is dominant. Business abounds within a complacent culture.

Companies in a mature stage often undergo a "consolidation" whereby they trim their management ranks and narrow their marketing focus. Usually, the latter is focused on their high-profit product lines in a more concentrated area. Product areas where the company sees little hope for increasing low profit margins are abandoned or spun off. Many conglomerates in the mature stage return to the businesses in which they have excelled. Others expand in acquired business lines. The need to develop new products or find new markets for existing products has surfaced, but fear that a new product will reduce sales of existing products makes for hesitancy. To be successful, however, it may be necessary to abandon the existing products and take the risk with new products. Productivity improvements are critical, especially those lowering costs; however, in some situations, cash flow is aided by depreciation write-offs.

Decline. The decline phase is the period during which market share is falling or the market itself is disappearing owing to technological obsolescence. Inefficient companies will be replaced by those meeting customer expectations. Cost-improvement programs take on strong importance, many times in the form of amputation of unprofitable operations. The need to develop new products or find new markets for existing products is now critical. The focus is on survival. An industry in the mature stage often has a global focus, with large companies having established major entry barriers.

In an attempt to jump-start the company and return it to a growth phase, sometimes a new research group is set up to think beyond the borders of the current research and development group. Because of such a group's isolation from the organization, it is often referred to as a *skunkworks*. Unfortunately, because of their isolation there is no effective way to capitalize on their efforts, which often are not relevant to the business.

To protect income on declining revenue, some companies may increase prices, which is the beginning of a vicious death spiral because the resulting decreased sales will trigger another round of price increases, followed by further decline in sales, and so on. Others may reduce the size of the product (while holding price) or combine decreased size with increased price—actions unlikely to increase sales. Others may introduce new features or benefits of the product in the hope this will help sales.

Procedural manuals exist on almost every topic, specifying the preparation of forms to get approval on everything from a dozen pencils to a multimillion-dollar capital investment. Form has become more important than substance. Commitment to the process has replaced commitment to results. Bureaucracy rules.

The organization is more formal in tone than in earlier phases, and first names are rarely used, regardless of how well known the person is. Individuals are oblique and obtuse in their statements, and the manner of presentation has become more important than the substance. Although the *Titanic* is listing badly, some crew members are methodically rearranging the deck chairs, oblivious to the fact that the ship is sinking! Putter clutter rules!

Embedded costs are high, but, paradoxically, cash is more likely to be available during this phase than most others, because of cutbacks in research and marketing expenses or the sale of part of the business. In capital-intensive companies, the strong cash position could be the result of depreciation allowances that have not been reinvested in newer equipment. Also, the book value of the stock may very well exceed its market value. Or even more dramatically, net working capital (assets less all liabilities including preferred stock) may exceed the aggregate market value for the company's common stock.

In this stage, many companies will be forced to diversify simply by nature of their product line. Mining, oil, and gas companies facing a dwindling natural resource must look to supplementary business lines. The projected exhaustion point can be set back by new discoveries, but they delay, rather than alter, the inevitable results. For some, this will mean other forms of geological exploration (such as minerals); for others, it will mean entering businesses where its products are an essential part of business (such as chemicals). Others may reach outside of the related business worlds and enter a completely new field. The decision to leave the energy business may not be related to demand but rather to supply.

The problem with food companies is the reverse one of leveling demand in many countries (related to population). Here the desire to diversify within the field leads some to different, higher-profit product lines or alternative preparations (such as fast-food outlets). For others, vertical expansion to include growing, breeding, and shipping may be a more logical approach.

To avoid taking the company into oblivion, the CEO and board of directors are looking to "catch a wave," as the surfers would say. They are looking for a market coming out of the first stage and beginning to explode in growth. By moving to an industry in this early stage, the company is able to reinvent itself by applying its expertise, shifting itself back to a growth phase. Sometimes the industry will do it by itself. Some argued years back that the pharmaceutical industry was in the maturity phase. There were no product breakthroughs remaining. Talk about being wrong! An explosion of new products repositioned the industry into the growth stage.

Ideally, the time to make this retro move is while in the late stage of growth or early maturity. It is far riskier to wait until decline sets in, not only because revenues are declining (although cash flow may be increasing) but also because the organization is becoming more rigid and less able to respond to a dramatic shift. This is a time when CEOs and other senior executives are most at risk because their board of directors may think them incapable of making the daring but necessary move for survival. They have been part of the problem rather than part of the solution. Failure to anticipate and act would be an indication of poor strategic thinking.

If poor performance leads to significant declines in the stock price, there is a risk that the company will be bought by a private equity firm that may bring in additional investors, known as limited investors (because of their limited liability). Having taken the company private, there no longer are any shareholders, only outright owners of the company. To buy the company, it was necessary to borrow heavily, which might account for a very significant percentage (e.g., 90 percent) of the purchase price being debt-financed. Thus, it is critical to improve the cash flow to be able to meet the debt obligations. Managers are hired to accomplish this requirement. These individuals are usually given very significant stock options at the beginning of their tenure along with other performance incentives. The start date is when the fund has been closed. The first fiscal year is typically called the *vintage year*. Performance is measured by an internal rate of return.

Private equity firms typically charge investors an annual fee (e.g., 2 percent) of the fund to manage the investment plus a stated percentage (e.g., 20 percent) of the profits, perhaps above a stated minimum (e.g., 8 percent). Some charge a fixed fee regardless of performance or some combination with a stated percentage.

The difference between a venture capitalist and a private equity firm is that the former typically invests in a startup company hoping to achieve a successful IPO. A private equity firm typically invests in a failing company in the mature or decline phase. And it hopes to turn the company around by moving it from a private company to a public company through an IPO.

An industry in decline is the result of a disappearing market (e.g., black-and-white TVs) dominated by several companies struggling with costs and excess capacity.

Turnaround, Sale, or Demise. The decline phase leads to one of three positions: turnaround, sale, or demise. *Turnaround* is clearly the most attractive alternative. It is intended to reposition the organization to an earlier stage, preferably growth, reinventing itself and could begin earlier (e.g., in the maturity phase). The focus is not simply on cutting costs but also on improving performance. *Sale* is when the organization believes a turnaround to be unlikely and begins the search for a buyer before the situation gets worse. This is often done under the guise of "exploring strategic alternatives"—most believe this means the company is looking to sell out. Efforts will be made to reduce costs in an attempt to make the business more attractive to a buyer—dressing it up for sale. *Demise* means the company has been unsuccessful with the other two alternatives, or may not have even had the foresight to attempt them, and goes out of business, resulting in a Chapter 7 bankruptcy (liquidation). If the company believes it can work its way back, it may go into a Chapter 11 reorganization, holding back the creditors as it tries to return to a profitable state.

There are many possible explanations for a company moving into a decline phase. They may be internal, external, or both. Internal factors might include poor management decisions, rising costs and declining prices, and a nonproductive workforce. External factors might include new competitors, new technology, declining markets, or a redefined market. Overnight carrier service companies soon learned that the fax machine would redefine the movement of hard copy. This market in turn was redefined by email.

To prevent demise, the organization must cut expenses. This includes shutting facilities, terminating employees, and writing off nonproductive assets. Fixed costs such as salaries and benefits are reduced where possible, but, at the minimum, frozen salary increases are replaced by variable pay plans with upside potential and downside risk. Substantial investments in company stock may be required of executives to reinforce the company's commitment to survival. It must then return to its core competencies (it probably does not have enough time to develop new ones), identifying products and markets that will help it to a brighter future. Time is of the essence, but the business must be viable: buggy whips, 33 rpm records, and manual typewriters would be difficult businesses to turn around.

New versus Old Economy Companies. Much is being made of the difference between the new economy (high tech) and the old economy (long-established, traditional companies). This difference between the "clicks" and "bricks" is often described in terms similar to those shown in Table 1.10. Whereas the old economy has high emphasis on salary, employee benefits, and short- and long-term incentives (except for a low emphasis on stock options), the new economy is virtually the reverse situation, with broad-based stock option plans going deep into the organization. Companies in the new economy also tend to use larger grants for new hires and persons promoted.

Actually, these are not so much differences in economies as differences represented by their stage in the market cycle. The new economy mirrors the compensation element emphasis in the threshold stage of development, whereas the old economy is representative of a combination maturity/decline phase. There are some exceptions, but this is a typical view of where new and old economy companies are positioned in the market cycle.

	EMPHASIS IN	
Pay Element	**Old Economy**	**New Economy**
Salary	High	Low
Employee benefits	Moderate	Low
Perquisites	Moderate	Low
Short-term incentives	High	Low
Long-term incentives (e.g., stock options)	Low	High

TABLE 1.10 Pay Elements in New versus Old Economy Companies

Old economy companies (positioned in maturity/decline) that attempt to change their pay practices to more closely align with new economy companies are advised to use this strategy to implement a turnaround, not simply to reformat pay practices.

Combination Lifecycles. Because companies have SBUs that may be in different stages of the lifecycle, programs must be customized to reflect those differences. Programs should also reflect not only current stages but also the future of the company or where it is positioning. Because of the fluidity of changing events and resulting strategies, it is critical to continually review the composition of a pay program to ensure it is consistent with objectives.

Stock Value versus Market Change. Recognizing that a number of factors outside the company's control can and do significantly affect the market value of its stock, some might argue that the relationship of stock prices to book value (i.e., shareholder equity divided by number of shares issued and outstanding) is as shown in Table 1.11. Note that during the growth stage, market price significantly exceeds book value; during maturity, the relationship is reversed; and during decline, book value pulls significantly away from market value. Market value in the threshold stage could be anything from low to high depending on how the stock analysts view the possible degree of success versus the probability of failure.

	MARKET STAGE			
Type of Plan	**Threshold**	**Growth**	**Maturity**	**Decline**
Market value	Low to high	High	Moderate	Low
Book value	Low	Moderate	High	Very high

TABLE 1.11 Stock Value (Market and Book) versus Market Stage

Changes in Lifecycle Stages. In any of the four stages, there are five possible events: remain, advance, sellout, turnaround, and bankruptcy. These are illustrated in Table 1.12 along with probability values. The latter are best viewed not in absolute terms but relative to each other. For example, in the threshold stage, bankruptcy is probably the most likely occurrence—a large percentage of startups fail. Advancing (or selling out to someone else) is also probably more likely to occur in the threshold stage than remaining put.

	PROBABILITY OF ACTION			
Action	**Threshold**	**Growth**	**Maturity**	**Decline**
Remain	Low	Low	Low	Low
Advance	Moderate	High	High	None
Sellout	Moderate	Low	Moderate	High
Turnaround	–	Low	Moderate	Moderate
Bankruptcy	High	Low	Moderate	High

TABLE 1.12 Action Probabilities in Various Market Lifecycles

Company Size. Although companies tend to grow larger as they move from threshold to later stages of development, that does not mean all companies become large. Some will remain small; others will become only moderate in size. One way to categorize company size is by sales (revenue); another way is by size of market capitalization. Regardless, although there would be differences in emphasis on each of the five pay elements based on absolute size of the company, differences are more likely to be influenced by stage in the market cycle. However, there are ways to dramatically increase or decrease a company's size. These will be reviewed next.

Market Life Cycle and the Compensation Elements

A comparison of the different stages of the market cycle goes a long way to explain stock price movement. When companies are in the development and growth stage, higher multiples are given to their earnings in anticipation of higher future profits, thereby resulting in rising stock prices. Companies in the mature phase can expect a sluggish market for their stock, and those in decline are likely to see their stock price head in the same direction. However, projections of the future based on past company performance are subject to significant error because the rate of growth is likely to be greater or less than in the past. This degree of miscalculation is compounded by the number of years used in the projection.

As emphasized earlier, a particular company may have units in different phases of the market cycle. Thus, although it may be possible to generalize as to a company's stage in the market cycle, there are different needs for different parts. For this, different divisional pay programs may need to be developed. Shown in Figure 1.7 are the eight divisions of a hypothetical company, Brucell, in relation to market stage and profitability. The size of the circles reflects the relative size of one division to another. One only has to contrast "1" (high profit in the threshold stage) with “8” (low profit in a decline phase) to see that one pay plan will not fit both situations.

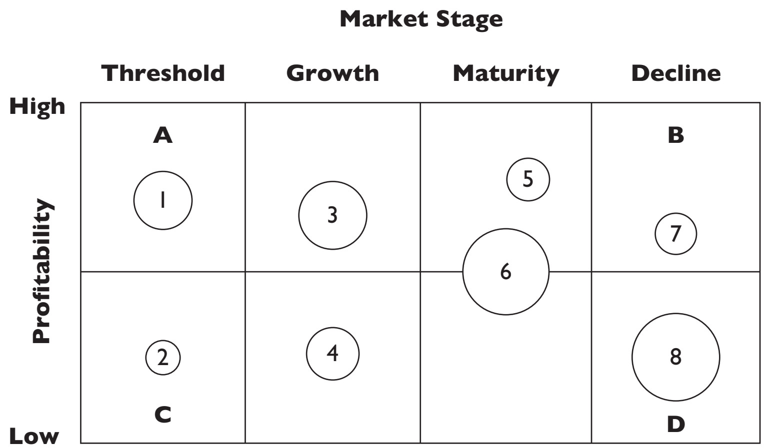

FIGURE 1.7 Market Stage versus Profitability

As compared with company plans, however, divisional incentive plans suffer a great disadvantage. Only rarely is a common stock traded on the market for a subsidiary; by financial definition there is no common stock for a division. But one could set up a phantom stock plan for a division and a common stock plan for a wholly owned subsidiary if its stock is publicly traded.

Even a true profit is often difficult to ascertain for a division or subsidiary (because of the decisions made by corporate, not divisional, management on cross-divisional pricing, assigned products, and assessments). Thus, the range of design possibilities for long-term divisional incentives is severely limited—often so greatly that a corporate plan is the de facto decision.

Determination of market phase is also an important frame of reference for viewing the importance of each of the compensation elements as shown in the matrix in Table 1.13.

	EMPHASIS BY MARKET STAGE			
Compensation Element	**Threshold**	**Growth**	**Maturity**	**Decline**
Salary	Low	Moderate	High	High
Employee benefits	Low	Moderate	Moderate	High
Perquisites	Low	Low	Moderate	High
Short-term incentives	Low	Moderate	High	Moderate
Long-term incentives	High	High	Moderate	Low

TABLE 1.13 Compensation Element versus Market Stage

Threshold. As Table 1.13 shows, the most important element in the threshold phase is the long-term incentive, essentially for two reasons. First, the need to reinvest earnings for marketing and production requirements places a heavy curtailment on direct cash outlays. Second, the potential for the company's stock prices to rise as it enters the growth phase should help it retain its top people. The latter is a strong case for the use of stock options.

Startups may literally begin in a garage or basement. When the product or service is considered viable, the individuals seek and receive backing from venture capitalists and from attorneys. As key contributors are selectively added, they may receive stock or stock options because of the scarcity of cash. As staff expands and money is more readily available from financial backers, cash compensation for selected executives is more available. However, equity participation is still the dominant form of compensation. New hires and ongoing employees both receive grants considerably larger than those of employees in growth stages. Equity awards, typically in stock options, are allocated on the basis of percentage of company or percentage of available pool.

The promise of probable future success shifts the attention from venture capital to an IPO. One or two years before this is likely to occur, the organization focuses on putting in place formal policies based on competitive analysis. This would include more formalized stock option grant guidelines, namely, eligibility, size, frequency, and vesting.

With the intent of giving executives an opportunity to participate in stock price appreciation from date of IPO, stock would be a key component of the pay program. This stock is typically described as *founder's stock* and, as such, may be narrowly defined as that awarded/granted to the entrepreneurs who founded the company or more broadly defined as any pre-IPO stock. A stock award perhaps equal to one times salary with a five-year cliff vest along with a mega stock option grant equivalent to three to five years of normal grants would address the objective of retention, tying the executive to the organization for five years. This might be supplemented with an employment contract protecting both the executive and the company.

Growth. During the *growth* stage, capital investment needs are still strong, but the company is in a good position to improve salaries and benefits (especially profit sharing) and set up some type of annual incentive plan. Long-term incentive plans, however, still have the major emphasis, as there is a strong interest in capital income programs tied to company growth. The period is identifiable as one during which pay plans become more structured and complex. During this phase, annual cash incentives tied to financial targets are becoming popular, whereas stock options continue to be dominant for long-term incentives. However, various types of three- to five-year performance plans are emerging. Perquisites are becoming more popular.

Maturity. By the time the company shifts into the *maturity* stage, the time ranges for investment opportunities typically become shorter than in the growth phase. Emphasis on cost containment as a major way to improve earnings becomes important. This is reflected in more emphasis on short-term than on long-term incentive plans. Return on investment becomes more important than product innovation. Budgets and internal financial measurements take on more importance than stock price and shareholder return, making performance-share and performance-unit plans more attractive than stock options. Long-term incentives start to shift from stock market to nonmarket valuation techniques as price earnings multiples start to slide. Perquisites start to increase in importance as psychic income becomes a partial trade-off for a decline in real income from incentive plans. There is increased emphasis on salaries, leading to increased importance of wider structural ranges because promotional opportunities (and their big pay increases) are less likely. Executives remain in job grades longer.

Decline. During the *decline* phase, the company must move aggressively to reduce expenses, not only shrinking the employee population but also reducing salaries and perquisites while introducing short-term incentives that will reward cost efficiencies. Assuming the company hopes to turn around, it will replace performance-share and performance-unit plans with stock options, or it may concentrate solely on internal financial measurements for the long-term plan since book value probably exceeds market value. Either method may be supplemented with restricted stock to ensure retention of key executives.

Organizational Structure Change

Virtually all companies begin as startups with the *founders* maxing out credit cards and financing the capital needs of the company by taking out loans and mortgages as necessary. The next stage is when *venture capitalists* are willing to put up money for an equity position in the company. By now, the founders have given themselves large stock option grants, hoping for a run-up in price when the stock goes public. However, care must be taken in the timing and grant price of stock options before the IPO, which will be handled by the *investment banker*. For example, the auditors may conclude that an option at $1 one month before an IPO offering at $20 should be ruled as "cheap stock"—namely, that the $1 grant is significantly underpriced. This may result in a charge to the earnings statement for all (or a portion) of the difference. This restatement of the earning statement will also affect an S-1 SEC filing. However, these stocks cannot be sold for a stated period of time after an IPO—typically 180 days. This is called a *lockup period*. It can be expected that when the lockup period expires, there will be considerable downward pressure on the stock price because of sales. Later, a company may decide to acquire or merge with another company, or it may want to divest all or a portion of its business. These phases are listed in Figure 1.8. All have executive pay implications.

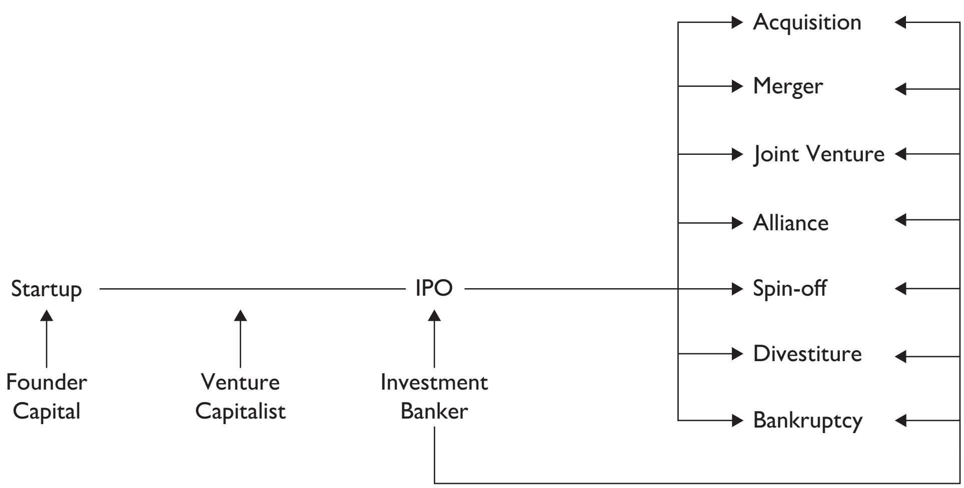

FIGURE 1.8 Structural Change of an Organization

Initial Public Offering. Reasons for an IPO include raising capital for expansion, deleveraging an earlier leveraged buyout, and removing a portion of the business not aligned with the company's vision and mission. Timing is critical. Waiting to have a longer track record may come at the expense of missing a prime market opportunity. It was believed that 1999 was a great time to do an IPO, but when the bubble burst a year later, the number of business failures far exceeded even pessimistic expectations. To some, IPO meant "investor pain overload."

If the company decides to undertake an IPO, it must be prepared to know what is required of a publicly traded company. It is important not only to know the requirements before proceeding but also to do a dry run on preparing the reports and releases to ensure a smooth transition from being privately held to publicly held. New functions such as investor relations need to be formed and staffed, and the extent that equity compensation will be a portion of total pay, not simply for the executives but for all others in the organization, needs to be carefully evaluated. It will be more difficult to ask for equity programs after going public, as it will dilute the ownership of the investors. The pay programs need to be aligned with the company's objectives and able to pass public scrutiny. Such objectives should be consistent with a stated pay-for-performance philosophy. And the extent and an investment banker must be selected. Experience with similar firms in the industry, including costs and capital raised, should be carefully reviewed. This selection process is often called a *bakeoff*.

The selected underwriter analyzes the firm's financial data, comparing them with rivals, to set a preliminary value for the company. This leads to setting a preliminary stock price. After the company agrees with the initial price range, meetings are set up with institutional investors to get an indication of interest. Typically, this is a grueling several weeks of cross-country (perhaps cross-continent) travel with several meetings a day with various fund managers. This travel, usually called a *road show*, is set up only after long hours of polishing the presentation and preparing responses to anticipated questions.

Based on this information, the underwriter sets the final IPO stock price the day before trading is to begin. Setting the IPO price is important—too high and investors are turned off, too low and the company is losing money. The lowest offering price acceptable to the IPO company is typically called a *collar*. A *prospectus*, filled with financial data as well as information about special risks and how the company intends on using the money, is prepared for filing with the SEC. A draft prospectus preliminary to the actual offering is called a *red herring* (because of the red ink on the top of the page). An agreement with underwriters that they can buy up to a specified percentage more of company stock during the first month of trading is referred to as a *green shoe*. When shares begin trading, they often do so at a premium to the initial offering price. Essentially, this is the result of an imbalance; namely, there are more buyers than sellers on the first day. It is not uncommon to see a 50 percent gain in the stock price on the day of the IPO. Those interested in a quick profit *flip* (or sell) their shares. For some companies, the rapid rise is a short-run phenomenon as sellers begin to outnumber buyers. If this happens during the *lockup period* when insiders cannot sell their stock, they see their profits disappear. A small gain in the stock price of a failing company is sometimes called a *dead cat bounce* (with apologies to animal rightists).

For their work, investment bankers will probably get about 7 percent of the IPO proceeds, with the lead underwriter getting about half of that amount. The lead underwriter not only sells the greatest number of shares but also arranges the deal and prices the stock. The higher the price, the more money the company and underwriter make. Secondary offerings in later years because of the need for more capital can also generate underwriting activity.

The company founders, employees, and venture capitalists could account for well over half of the stock after the IPO. They are all subject to a lockup. This is not incarceration but a time restriction before they can sell the stock. This could be as short as 90 days or as long as three years. But most likely it is 180 days. It can be expected that when the lockup expires, there will be downward pressure on the stock price because of sales.

An IPO of a self-standing company typically occurs during the threshold stage, whereas an IPO from a parent organization is typically done in the latter part of the growth stage or in maturity. After the IPO is completed, it is important that the company increase revenues so it can reinvest in the business. Some companies attempt this solely by internal actions, often called *organic growth*. Others look externally for ways to expand the scope of their business, namely, through mergers and acquisitions (M&As).

Mergers and Acquisitions. A *merger* is the joining together of two companies to form a new organization. It is a decision to buy rather than to grow internally, which is typically called organic growth. Typically, these companies are of comparable size, and a new stock is created. With an acquisition, one company clearly buys out the other. *Acquisitions* are easier to finance if the acquirer's stock has been on the ascent and the stock of the company being acquired has been dropping. However, the latter is likely to be quickly reversed by speculative investors. Until mid-2001, wherever possible, pooling-of-interest accounting was attempted. This meant both income statements and balance sheets were combined, unless the acquisition was deemed to be performing poorly, in which case the asset had to be written down because of an impaired value. However, to qualify for pooling, companies are required to use their common stock (not cash) for the acquisition and are limited for two years in stock buybacks and selling acquired company assets. Under *purchase accounting*, the acquired company's assets are written up to reflect current market value. The increase over book value of the acquired company is considered *goodwill* and must be amortized, thereby diluting earnings. In accord with Accounting Principles Board 16, "Conditions of Pooling of Interest Methods of Accounting for Combination," pooling rules must be used if they apply. If not, purchase accounting must be used and the difference between purchase price and net assets amortized or written off over a 40-year period. However, that changed in 2001 when FASB eliminated pooling but gave some relief on the treatment of resulting goodwill.

In both mergers and acquisitions, it is important that the acquirer and merged companies undertake due diligence to ensure the equity programs and liabilities are clearly identified and quantified. After closure, employees and service providers should understand their responsibilities. Expected results should be based on workforce synergies, not simply on the combination of assets and customers. The return on investment must exceed the cost of capital, and the value created must be greater than that of its key competitors. A *copycat merger* is a deal followed by others in the same industry.

Companies planning mergers or acquisitions would look to investment bankers to structure the deal. In return, the bankers would likely receive fees ranging from 0.5 to 1.5 percent, depending on size, with the highest fees going for the smaller deal. An unwelcome offer to buy a company is called an *unfriendly takeover* by a *black knight*. In other situations, it may simply be a *bear hug*, with a company threatening a takeover but willing to back away for *greenmail*—a legal form of blackmail. If another organization considered more attractive by the company being pursued enters the scene, it is sometimes referred to as a *white knight* (charging to rescue the fair maiden). The takeover could be by a company or by venture capitalists who see the breakup value of the company exceeding its market price.

After the signing of confidentiality agreements, financial and other experts are sent in to analyze the company's strengths and weaknesses. This is the *due diligence* stage. If the results are acceptable, an *agreement in principle* is signed. Implementation details are worked out, and the deal is approved by the respective boards. Throughout the entire process, it is critical that all interested parties be kept informed.

During discussions, both sides typically sign *confidentiality agreements* to prevent the other from using confidential information should the talks fail, as many do. However, even with enforcement of these agreements, companies gain a better understanding of their own competitive strengths and weaknesses.

M&As could occur in any stage of the market lifecycle, although the later rather than the earlier stages are more likely to see such activity. The key issue is which is better—to build or to buy? Among the considerations are key product portfolios, research and development opportunities, time to market improvements, cost-reduction opportunities, management depth, culture, and the expected rate of return on capital before and after the merger or acquisition. Is the focus on cost reduction or revenue growth? Diversification by customer, products, or geography may also be a factor.

In a merger, it may be appropriate to design new pay programs; with an acquisition, the issue is whether to bring employees into the acquirer's programs or permit them to continue with their current plans. It is important that employees of the acquired or merged company clearly understand the effect the action will have on their pay, benefits, and job security. The reasons for such changes must also be understood. Whether it is an acquisition or a merger, stock options will be recast based on the stock prices of the two companies before they were combined. Executives of either company may be given a *transaction bonus*—payment for staying until the transaction is completed. This payment is not only to keep the individual with the company but also to gain cooperation in making the deal. Post-transaction consulting agreements may also be awarded to assist in post-deal issues. Executives in both probably have employment contracts specifying severance agreements; the contracts should therefore be carefully examined before awarding transaction bonuses or post-transaction consulting agreements.

At some stage in the market lifecycle, typically maturity, although it could be earlier or later, the company looks to shed certain businesses, typically because they do not fit with core competencies. This divestiture is done through either a sale to another company or a spin-off to the company shareholders.

More acquisitions and mergers fail than succeed because of incomplete analysis, inadequate preparation, and poor execution.

Joint Ventures and Alliances. *A joint venture* is when two companies form a third, either with each owning half or with one having a majority stake. An *alliance* is a formal agreement between companies on respective responsibility without forming a new company. The alliance may range from a simple licensing agreement (often not tied to the core business), whereas a strategic alliance is part of a major strategy to increase shareholder value. An example would be comarketing a Company A product with Company B because the product fits with B's strategy and it has no comparable product.

The company must determine why it wants to take the action. Is it because of products or technology? Is it to fill gaps or create new borders? Key structural questions include the following: Where is the target on the life cycle? What is the speed to market of key products? What are the strengths and weaknesses of key people? Are we going to have a problem keeping key people? Is the culture one we want or need to change? Are we going to assimilate brands within our current structure? Will the units be folded into our structure or set up as a standalone organization? The key question that must be answered is: How do we capitalize on the action?

When two companies have different complementary strengths (e.g., one has a strong research portfolio and the other manufacturing capabilities), it may be appropriate to set up a joint venture (JV). The new organization is staffed with individuals from both organizations, and one of the requirements will be to set up an executive compensation program. Coming to an agreement may be difficult, especially if the partners have equal votes and different views. Another problem to be addressed is what happens to the pay plans when the JV is dissolved (as most eventually are). Exit strategies should be agreed upon at time of formation, not at time of dissolution.

An alliance is a contractual agreement specifying responsibilities over a period of time without forming a new company. It is formed either to increase revenue or to reduce costs, or both. For example, a company recognized for its marketing excellence might be approached by another with a new product that is reluctant to take the time and expense to expand its own sales force. Assuming the marketing leader has the available resources and the commission arrangement is attractive, a comarketing alliance will be formed. Similarly, a company may choose to form an alliance with a research organization rather than expand its own research capabilities. In return for the investment, the investor will have rights of first refusal on marketing any discoveries through an agreed-upon royalty arrangement.

Alliances are far less costly than acquisitions or mergers and can be just as successful (if not more so) in many situations. Since the organizational structure of each company has not been altered, there is little effect on the executive pay plans. Nonetheless, alliances must be continually reviewed to ensure they are appropriate and properly aligned with organizational needs. Most importantly, exit strategies identifying when and how companies will end the relationship (before they commit to the deal) are essential. For example, the return of trademarks to the parent organization in a JV is critical; otherwise, a third party may end up using them.

Divestitures (Sales and Spin-offs). The divestiture sale of one company is the acquisition of another. The sale may range from brand names only to full businesses (including plants, buildings, and people). A divesting company has an obligation to protect its employees transferring to a new owner. The sale may be for cash or stock or both.

In a *spin-off*, the divested business is given (not sold) to existing shareholders. This is done by creating a new stock. If the transaction is carefully done, it should be able to qualify as a tax-free exchange, meaning the shareholder has no income tax liability. It is hoped that the sum of the two stock prices will exceed that of the original company. This makes sense when a sale is unlikely to improve shareholder value and there are customer and/or market advantages to the action. If that does not happen, some companies do a *spin-in*, simply reversing the action.

With a spin-off, care must be taken in crediting or protecting existing pay programs while designing a new pay program for the spin-off, based on a newly defined survey peer group. Stock options from the former company are typically converted on an equivalency basis, namely, (1) no reduction in ratio of exercise price to market price, (2) the option spread is not greater, and (3) the vesting and other option terms remain the same. This is described more fully in Chapter 8 on long-term incentives.

A key difference between a spin-off and the earlier-described IPO is that with an IPO, stock is sold to new shareholders. With a spin-off, stock is given away to existing shareholders.

The objective of an IPO is typically to raise capital, enabling the organization to invest in buildings, equipment, and people. However, it might also be to reverse a leveraged buyout (LBO), taking down debt and liquefying investor holdings. A spin-off is frequently done to sharpen the focus and direction of an organization, capitalizing on its core competencies and, hopefully, increasing shareholder value.

Bankruptcy

If all other attempts to restructure the organization fail, the only act left is bankruptcy. With a Chapter 7 bankruptcy, debtors are no longer responsible for unsecured debt as the company is liquidated. With a Chapter 11 filing, a business is permitted protection from creditors while reorganizing. With a Chapter 13 bankruptcy, debtors are permitted to hold on to some assets while paying off debt in installments.

Strategic Thinking

In this rapidly changing world where technological advances are coming faster than some can absorb and customer needs are ever changing, it is difficult to believe that strategic planning (looking ahead 5 to 10 years) can be anything more than an interesting exercise resulting in a beautiful book that will have little resemblance to what actually unfolds.

That does not mean companies should sit back, watch things happen, and hope to make the right decisions. Companies must engage in *strategic thinking*, always looking to the direction and rate of change. In doing so, a company must decide whether it wishes to be a pacesetter or one that capitalizes on established changes. The first probably emphasizes product innovation. The second looks to operational effectiveness and customer identification. Strategic intent is the alignment of internal and external factors. The steps in the process are shown in Figure 1.9 and illustrated as a function of time in Figure 1.10.

The Vision. Although sometimes belittled, many are successful because they start with a dream. It is analogous to the child who determines what she wants to be when she grows up. This is the vision or description of the desired future of the organization. Perhaps the company's vision is "to thrive on exceeding our customer communication needs." To the extent that this comes after pertinent input, it enhances the probability of relevance. Saying at the age of seven that you want to be a doctor—unaware of the requirements—is a lot different than if a few years later, after having talked with a doctor, you still want to become such a professional.

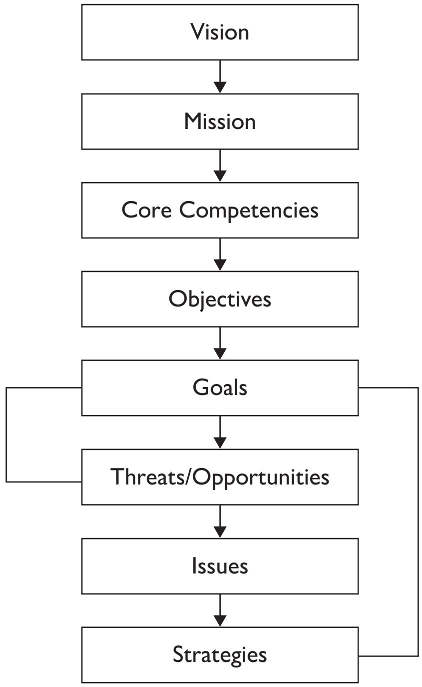

FIGURE 1.9 Strategic Thinking Process

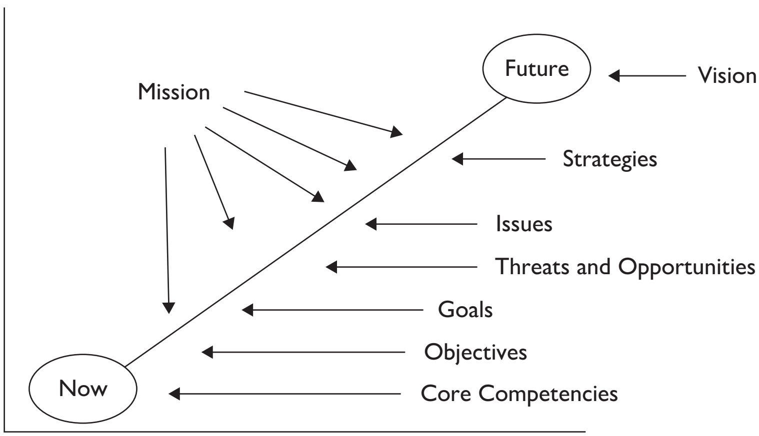

FIGURE 1.10 Strategic Thinking Illustration

Some believe the vision should be attainable if the company is successful in its mission. Others believe the vision should be inspiring but unattainable. Clearly, the late President Kennedy had an inspiring (and difficult but attainable) vision when he saw an American walking on the moon before 1970. And the late Martin Luther King, Jr., articulated his vision in the famous "I Have a Dream" speech, which, unfortunately, is proving difficult to achieve.

If the vision has been attained, it must be replaced by a new vision. This suggests that shorter-range visions will require more updating than longer-range visions.

The Mission. Since there is a recognizable gap between the now and the vision, the journey needs to be described. This is the *mission*, or how one achieves the vision. Building on the previously described vision, perhaps the mission is "to earn the trust every day of thousands of new customers while retaining the trust of existing customers, never having lost one because of violated trust."

Core competencies are the things a company is very good at doing. They must align with the mission and vision. If not, either the vision and mission must be altered to conform to core competencies or the latter must be changed to enable achievement of the mission and vision. Obviously, it is much easier to do the former than the latter; that is, to develop a business plan.

Companies sometimes stray from focusing on core competencies and seek to diversify their investments and/or capitalize on perceived resulting synergies. However, investors often do not concur with this boardroom logic—if they want to construct a diversified portfolio, they will do it by selecting an appropriate mix of companies themselves. Companies that attempt to replicate a diversified portfolio within their organizational structure may find that the composite is worth less than the sum of its parts. The result has been companies selling off noncore businesses and returning to focus on what they do best. By being the best in their industry segment, they hope to be the selection of every investor who wishes to put money in that market sector.

However, even companies apparently in the same sector are often significantly different. For example, in the insurance sector, property and casualty companies require large amounts of capital to respond to natural catastrophes, whereas life insurance companies must balance a lump sum payment protection of dying too soon versus an annuity payment of living too long.

Objectives and Goals. The mission is further refined in terms of qualitative targets, or *objectives*. The objectives are broken down into quantitative targets, or *goals*. An example of an objective might be "to bring to market products that enhance the customer's quality of life." A goal that might relate to this objective could be "to introduce product 'A' in all of North America by the second quarter next year and in the European community by the first quarter of the following year at a price recapturing cost and return on investment within three years." Some reverse the terms, calling the goals the qualitative and the objectives the quantitative. For this reason, confusion sometimes exists when talking to someone from another company. Hopefully, there are no such confusions within the company. Defined goals and objectives could also be identified as *critical success factors* (CSFs). Performance standards tied to these CSFs must be put in place with a measurement basis if a pay-delivery system is to be a reinforcement of desired outcome. The performance measurements are reviewed in Chapter 2 and should be tied closely to the core competencies so critical to success.

Threats and Opportunities. Goals may be easier or more difficult to attain based on perceived threats and opportunities identified by an environment scan of not only what is happening but what is likely to occur as well.

Let us highlight examples of the type of information one would examine to determine the presence of 10 kinds of threats and opportunities as shown in Table 1.14.

	THREATS AND OPPORTUNITIES	
	External	**Internal**
Nature	A	B
Economy	C	D
Business	E	F
Law	G	H
Culture	I	J

TABLE 1.14 Scan for Threats and Opportunities

Nature. What is the impact of the change in seasons and of natural disasters (A) on the company? Internally (B), the question is, how can the company maximize the opportunities and minimize the risks?

Economy. External economic (C) factors would include population, both customer and workforce. The size and financial ability of the customer base are critical to the organization's success in selling its products and services. The size, composition, and education of the workforce have an impact on the ability of the organization to meet its internal, core-competency staffing needs (D). What is the level of pay of executives and others? Are needed skills available or in short supply? Are recruiting pay premiums needed? An internal assessment of the skill base of employees is a related matter, along with the ability to retain key talent. Capital is another key external factor. What is the availability of either borrowing or equity financing? What are short- and long-term interest rates? Is the publicly traded stock market in a bull market (increasing stock prices) or bear market (falling stock prices) cycle? Internally, what is the company's cash flow ability to meet its needs? At what rate are technological changes outdating existing products and services?

Business. An external scan (E) would define market size for current and future products and major competitors. Internally (F), the focus will be the ability to meet customer requirements of quality, availability, and price, and the relationship of pay vertically in the organization.

Law. A look to the outside also examines what is present and likely to happen with legal requirements (G) imposed on the organization. Legislation, regulation, and litigation are more prevalent in some parts of the world than in others. In addition to state and federal laws, a number of alphabet soup organizations dramatically affect how an organization will do business. In the United States, they include the EEOC, EPA, FASB, IRS, and SEC, to name a few. Internally (H), the organization has to determine what it needs to meet these requirements and prescribe a code of conduct. Laws and regulations can have a high impact on each of the pay elements.

Culture. An external look (I) examines the type of society present. Depending on the country, it ranges from autocratic to democratic to socialistic. The type of government and its stability are key considerations in determining whether to enter that market and, if so, at what pace. What are the mores and values of the society in question? How do they relate to the organization's products and services? An internal review (J) should focus on the company's culture.

What is company culture? The organization's *culture* is the composite of values and beliefs that it considers core to its existence. It is the way it does business. It is the way it treats customers and employees. Companies operating in different countries must be careful not to export a country-of-origin culture. Although it is important to hold on to core values, it is also important to adapt to the local culture within a universal code of conduct. As shown in Table 1.15, these values can be expressed in both *hard* and *soft* terms, internally and externally. It is obviously more difficult to measure the qualitative (soft) than the quantitative (hard).

	MEASUREMENTS	
Where Found	**Hard**	**Soft**
Internal	Operating income, net income, revenue	Talent depth, talent ability, employee satisfaction
External	Stock price, market share, peer performance	Talent availability, customer satisfaction, community satisfaction

TABLE 1.15 Measurements of the Organization

To ensure conformance, company culture rewards compliance and penalizes shortfalls. Thus, it is not simply results but also the process and behaviors that are important. The compensation system is one of the most powerful vehicles for reinforcing desired values.

To illustrate, assume customer satisfaction is considered to be a key desired value. First, we need to identify *who* the customers are and *what* they want. Following this, the focus might be on continuous improvement, while the drivers of change might be price, quality, service, and timely delivery. It would be difficult to be successful with a pay program emphasizing salary and benefits. Rather, an annual incentive plan focused on decreasing costs, response time, and returns, or a long-term incentive plan based on increasing market share, would be more logical.

Culture clash is a major reason why acquisitions and mergers that appear so logical nonetheless fail. Imagine reconciling the differences between a culture that considers its employees to be assets, spending considerable time and expense to optimize their growth and development, with another that views them as expenses, frequently terminating their services through periodic downsizings to improve the earnings statement. Similarly, there is a distinct difference in the importance of the pay element in an egalitarian versus a *distinctive*, or class, system as highlighted in Table 1.16.

Employee benefits rate a "high" in the egalitarian or equality organization, while in the distinctive and differentiating organization incentives and perquirites rate "high."

A *performance-driven* culture would be similar to a distinctive one except that perquisites would be dropped to a low level of importance. Hence, rewards are differentiated in a meaningful manner because a good assessment system with meaningful metrics is tied to demanding standards, not to organization level.

	IMPORTANCE	
Element	**Egalitarian**	**Distinctive**
Salary	Low	Moderate
Employee benefits	High	Low
Short-term incentives	Moderate	High
Long-term incentives	Moderate	High
Perquisites	Low	High

TABLE 1.16 Cultural Differences in Pay Elements

A performance-driven culture has the following characteristics: demanding standards, good assessment system with meaningful metrics, and meaningful rewards for desired performance. Desirable characteristics are the basis for hiring, promoting, and termination of nonconformers; important increased skills are often attained through horizontal job movement. Strong leadership is essential.

Culture can also be defined in terms of rewarding risk versus compliance, creativity versus conformity, and values versus results. Therefore, it is critical to define the current culture and determine whether to maintain or change it. Namely, is it consistent with the vision and mission? A highly regulated culture that penalizes failure would have a difficult time succeeding if product innovation were key to success. If changed, the direction and degree of change must be clearly articulated. How does the organization differentiate itself from its competitors? How is work organized? How is the organization structured? How are employees treated? How are resources allocated? What gets communicated and how? Are these consistent across organizational units? What is the *line of sight* between individual and group objectives and goals?

Is it surprising that a pay plan that may be very successful in one organization would be a failure in another? Of course not, if they had different cultures. Company culture is a major factor in designing pay delivery systems since it reinforces desired behavior and outcomes.

Another way of looking at how these various components come together is shown in Figure 1.10. Degree of success is shown on the *Y* axis and time on the *X* axis. Starting with where a company is now, compare it to its vision of the future. The difference is addressed by the mission, or how to achieve the vision. Having assessed the threats, and opportunities along the way, the company has developed a major business strategy with supporting objectives and goals. The next step is to operationalize the process.

Issues. An assessment of the threats and opportunities versus achieving the stated goals and objectives will identify issues that need to be addressed. For example, a bear market will jeopardize plans to do an IPO, an expected hot and dry summer should present opportunities for soft drink sales, a new competitor with a better-priced product than our bestseller will create problems, and a new EPA standard will raise manufacturing costs. It is imperative that the issues raised be addressed by strategies. The best strategies are developed outside-in, not inside-out. Namely, it is by carefully examining the external threats and opportunities and not focusing solely on the internal factors that one is likely to have the most impact.

Strategies

The word *strategy* is derived from the Greek word *strategos,* which means commander or general, the one who decides on action taken to defeat one's enemies. It is a fitting meaning in the business world. Business strategies capitalizing on threats and/or opportunities to achieve goals and objectives include product additions and deletions; centralization versus decentralization; acquisitions and divestitures; quality and process positioning; and expansion and downsizing. However, these strategies are subsets of an overall major business strategy. As shown in Figure 1.11, there are six different types of strategies, each focused on one of the earlier described stakeholders. They are as follows:

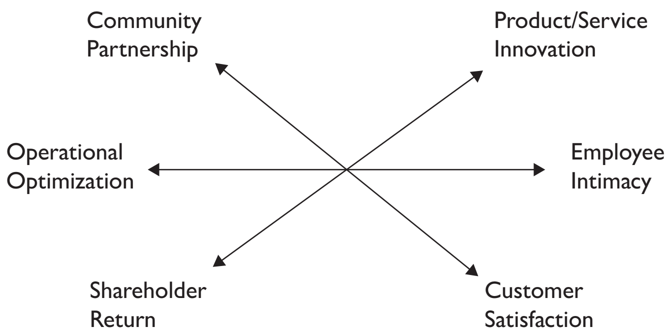

FIGURE 1.11 Strategy Focus

- **Product/service innovation** focuses on creating new markets with new or existing products/services.
- **Employee intimacy** focuses on an employer-of-choice objective, creating a work environment where individuals want to come to work and to give their best efforts.
- **Customer satisfaction** means providing reliable products/services at prices the customer considers excellent value. The emphasis is both on getting new customers and on getting existing customers to buy more.
- **Shareholder return** means increased dividends and rising stock prices to create shareholder wealth.
- **Operational optimization** focuses on productivity (cost, quantity, and quality).
- **Community partnership** means providing plenty of good-paying jobs and not contaminating the environment.

Most companies engage in at least several of these business strategies. In designing an executive incentive plan, it is important to prioritize and weigh their respective importance, recognizing that some are more in conflict than complementary—a fact that will become obvious later in the book when reviewing the design of incentive plans.

It can be argued that the flowchart for business success often begins with a product or service followed by a review of potential market and customers. Prototypes are then tested and refined. This is illustrated in Figure 1.12.

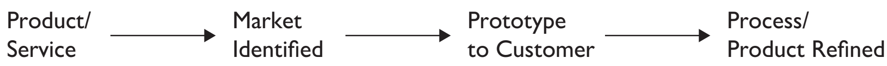

FIGURE 1.12 Product Seeking a Customer Model

Figure 1.13 illustrates how major business strategies can support desired outcomes resulting from market analysis.

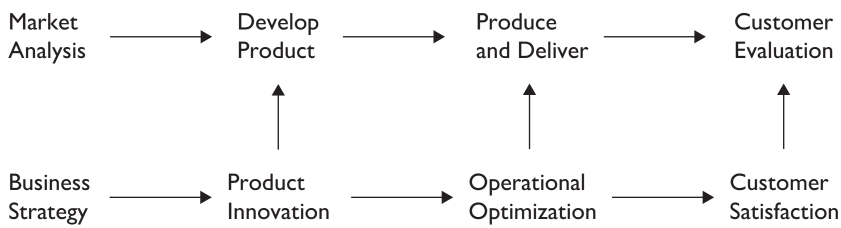

FIGURE 1.13 Business Strategies Supporting Major Actions

Market Cycle

The stage in the market cycle of both the company and its various strategic business units and comparable information for their respective industries is critical in the strategic thinking process. An SBU in the threshold stage with an industry in the maturity stage has a considerably different probable future than an SBU in the maturity stage with an industry in the threshold stage. This can be further developed using a market performance versus dollar return analysis such as shown in Figure 1.14,

Aids to product planning can be developed based on market and financial factors. A simple version of this is shown in Figure 1.14. The two criteria are "dollar return" and "market performance."

Obviously, the grid could be more refined; however, even this simple version shows where a combination calls for certain actions:

- **Combination A** This ideal situation is a prime candidate for additional investment, assuming the industry is in the threshold or growth stage.
- **Combination B** Investment needs are directed to improving the strength of market performance. However, this must be assessed in terms of probable success; investment without improved market performance may turn this into a D combination.

- **Combination C** Probably not likely to be a candidate for additional investment, this situation could provide a source of capital for other projects.
- **Combination D** This is a prime candidate to be deleted; continuation is based on the extent to which deletion would adversely affect the product line (and/or currently absorbed, overhead charges) and lower other products to C or D combinations.

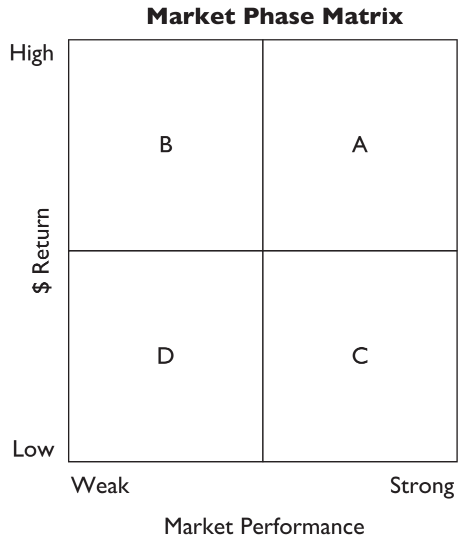

FIGURE 1.14 Dollar Return versus Market Performance

This type of analysis is very helpful since it places each product in perspective as well as shows where new products are needed and what to do with the current product line. Suffice it to say that from these reviews, issues will be identified and strategies described on how to overcome the obstacle or maximize opportunities to achieve the goal.

Companies must determine what their customers want most and do a better job than anyone else in providing it. Is it price? Product differentiation? Quality? Customer service? Purchase ease? Successful companies will prioritize these and identify a primary and secondary objective. They will strive to be the best with the primary objective and at least as good as the competition with the secondary objective. Successful companies will also build entry barriers, making it difficult for other companies to enter the market. Large capital requirements and a strong brand name are two examples.

The relationship between objectives and goals and the executive compensation program, especially incentives, must be clear and understood by all stakeholders. Naysayers claim that pay for performance would do nothing to motivate employees to work any harder. They are already going "full speed." This is probably true. Pay for performance would do little to increase their efforts, but it will do a lot to *focus* their efforts. It will reward them for achieving their goals and penalize them (by withholding pay) for not achieving them. Pay for performance is not about working harder—it is about working smarter.

Typically, companies will select one business strategy as their dominant theme with another as a supporting strategy. What one does to excel is the business strategy. How one excels in this strategy is based on the organization's core competencies.

It is critical that an organization have core competencies that support its intended strategy. Operational optimization will require strengths in producing products and services; product/service innovation will require strengths in research and development; and customer satisfaction requires strong sales and marketing competencies. It is easy to see the difficulty in shifting from one strategy to another because of the changes required in developing new core competencies. Only by linking the organization's core competencies with an appropriate strategy does the organization have a chance at achieving a sustainable competitive advantage.

Companies typically start out with a single product or service. Only over time do they expand their base. Often, this is done without clearly defining their strengths. As a result, the market may penalize their stock value. As organizations seek new products and/or markets, it is critical that they be consistent with core competencies and strategies. If not, one or the other must be changed. Constant discipline and communication are essential. New products, services, and competitors require a review of business strategy to ensure optimal targeting.

Downsizing may produce financial savings; however, sustained growth requires increasing the capital- and employee-resource base while also increasing the productivity of both. Companies that have focused on downsizing may have weakened their effectiveness. Reduced labor costs may improve the income statement, but is the company able to maintain, much less expand, its market share? Has cost cutting positioned the company for sustained productivity enhancement, or is it simply making do with less? Is sufficient investment being made in research and in the development of intellectual capital? It is difficult to grow to greatness from a shrinking base.

In setting strategy, one must identify the extent of uncertainty of future events and determine how and when such ambiguity will remain. The greater the uncertainty, the more flexible the strategy must be in order to adjust to changing circumstances. Typically, decisions must be made quickly with incomplete information. And even the best strategy will have to be periodically updated. Business is what happens while making future plans!

Annual Planning Process. An example of a schedule that might be used in a planning and review process is found in Table 1.17. As one can see, it is a never-ending loop. The one shown is annual. It could be condensed into a fraction of that time.