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LEADERSHIP

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BY DAVID REIMER AND ADAM BRYANT

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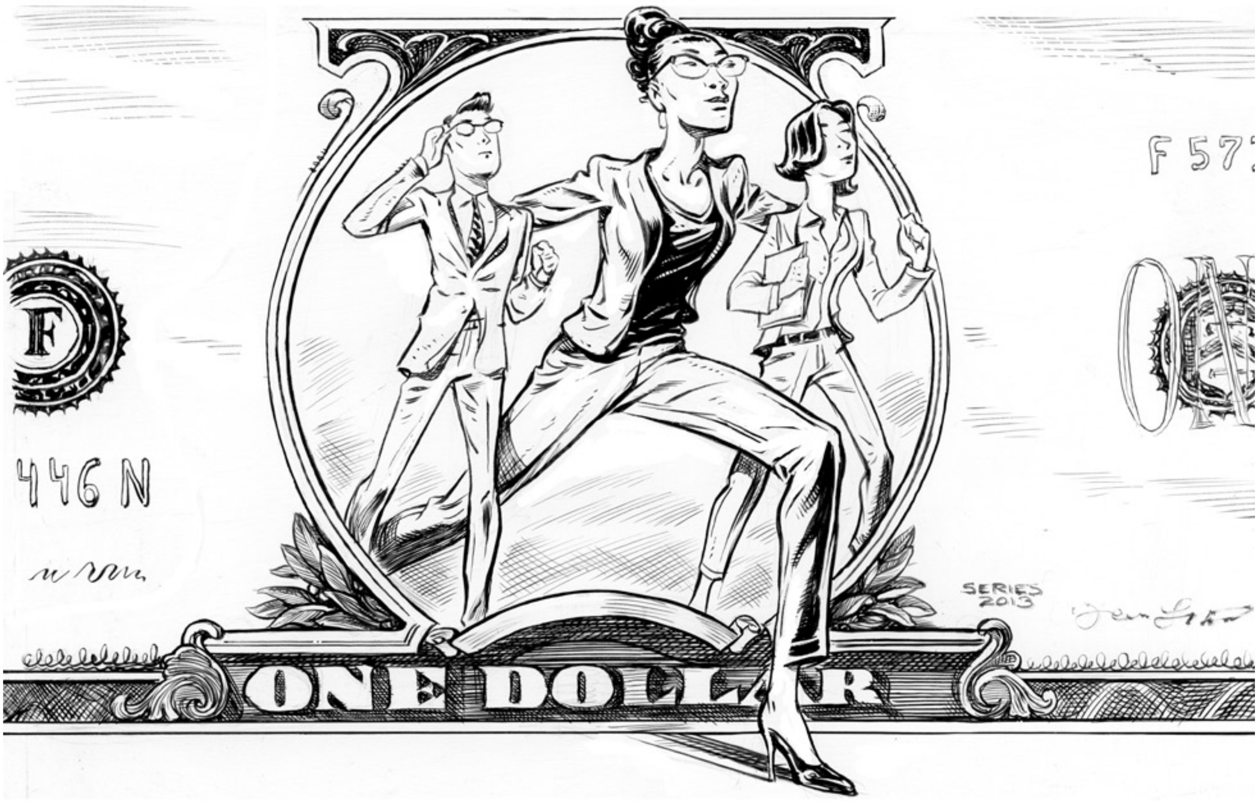

Incentives for a strong leadership culture

Three key pay and performance metrics can help define and influence an organization's values.

by David Reimer and Adam Bryant

Illustration by Lars Leetaru

CEOs and leadership teams spend a lot of time and energy defining and discussing corporate values, but a company's most powerful cultural signals aren't communicated by talking points. They're determined by who gets promoted and who receives outsized rewards. Yet compensation and bonus frameworks in most organizations are still based almost solely upon financial results. In an effort to rule out subjectivity, such plans emphasize — and often focus exclusively on — achieving numerical targets. This oversimplified focus on the *what* of results, without consideration of *how* the numbers were achieved, has triggered unintentionally lopsided cultures that promote short-term thinking and a tolerance for the proverbial high-performing jerks.

For boards, this is increasingly a problem. Waves of scandals (including #MeToo), falsified sales figures, and faked emissions reports have prompted a couple of recurring questions: Where was the board on culture? And what are they paying the CEO for? With pay ratios between CEOs and the average worker at record highs — 278:1 in the U.S. in 2018, compared to 42:1 in 1980, according to the AFL-CIO's Executive Paywatch — the optics of compensation as it relates to culture also are in the spotlight.

Kevin Cox, the newly appointed chief human resources officer at General Electric, reflecting on the consequences of companies maintaining a purely numerical focus, says, "You can have a very strong MBO [management by objectives] culture, but once you run that playbook for a couple of years, what do you have for an encore? Are you building great leaders who can take the company to the next level?"

Board members often struggle with these questions, even as they are expected to assume greater responsibility to influence culture. One of the most constructive yet underleveraged means by which boards can help management — particularly the CEO and chief human resources officer — engineer a desired culture is to focus on the most powerful signals in any organization: how performance is defined and incentivized, and who gets promoted and fired.

A small but growing number of businesses are innovating in this space, creating compensation plans that place more weight on how results are achieved while still incentivizing business performance. For much of corporate governance, culture is new territory — at the board level, in the C-suite, and in the design and execution of compensation plans. But increasingly that learning curve is viewed as worth climbing.

A rewarding culture

Broadly, the areas of evaluation for a compensation approach focused on the *how* fall into three categories. The first identifies ways to measure and reward managers for baseline performance — those numerical targets — but also to contextualize performance within the desired values of the company. A second broadens bonus assessment to include bigger teams or the entire company, which incentivizes helping colleagues succeed and puts a spotlight on collaboration across a matrix or outside one's silo. The third category ties more closely to promotion and considerations of future potential, weighing demonstrated behaviors against the management and leadership skills deemed critical for delivering the next generation of the business strategy. "More and more, I think that subtle aspects of business — on how you manage people, diversity, and the more social-oriented aspects of jobs — will be incorporated into how individual performance factors get weighed," says Helene Gayle, a director on the boards of Colgate-Palmolive and the Coca-Cola Company.

There is no simple template for creating a multidimensional compensation system, but there are examples of how to use short- and long-term incentives and promotions to focus management's attention on the desired leadership behaviors linked to a desired corporate culture. The examples below illustrate different approaches that companies have taken to align their compensation and promotion practices to reflect their corporate values. In some cases, these approaches have meant creating new ways to measure and reward success beyond numerical targets. In others, they have meant rewarding employees more for their team performance than for their individual contributions. And although it is always difficult to separate correlation from causation, the companies that have instituted such policies can point to track records of success.

The 60:40 bonus rule

Kronos, a workforce-management software company based in Lowell, Mass., near Boston, has been working for years to create a culture that rewards effective leaders for results that go beyond the simply financial. Aron Ain, Kronos's CEO, said his learning curve started in 2015, when the company introduced its Courage to Lead training program for managers. Ain had long seen the impact of effective managers on teams, in terms of both results and retention, and he wanted to use training to improve the skills of all managers. He assumed that if people went through the training program, they would be better managers because of the experience.

"Then we asked ourselves, 'How are we measuring whether they really took to the training we delivered?'" Ain says. "There were some people who became really effective after the training as leaders, and there were some who were still struggling."

That led the company to create its Manager Effectiveness Index, which scores every manager twice a year based on ratings from team members. The score is derived from 19 questions — such as "Does your manager have a deep concern about your career and future?" and "Does your manager discuss with you what your personal ambitions and goals are?" — that are worded specifically to measure the relationship employees have with their manager, rather than with the company overall. The answers can range from "strongly disagree" to "strongly agree."

With a measurement system in place that sought to clearly identify who was an effective manager, Kronos developed incentives to send an unmistakable signal that leadership mattered. Sixty percent of a manager's bonus at Kronos is based on financial performance, and 40 percent is based on leadership skills. "We've made it clear to people that it's just not what you do that's critical to us — it's also how you do it," Ain says.

Furthermore, only top-rated managers get promoted or receive significant bonuses. Kronos created five labels for different levels of performance. The highest-rated managers are called role models, and those in the second-highest tier are called exceptionals. Nobody below those top two tiers is considered for a vice president–level position. "Why would we promote you if you're in the fourth quartile?" Ain said. "Think of the wrong message that would send."

Annual turnover is down to less than 1 percent for role models and 2 to 3 percent for exceptionals, compared to an overall turnover rate of about 7 percent at Kronos. “We’re doing these things so they won’t ever want to go anywhere else,” Ain said.

The new approach to rewards has been in place for four years. Over that period, Kronos, which is privately held, has seen top-line growth increase 40 percent and profitability improve, according to Ain.

More than the sum of its parts

At Harman International Industries, a Connecticut-based U.S. subsidiary of Samsung Electronics that specializes in automotive audio systems, CEO Dinesh Paliwal has been trying to instill throughout the company the idea that collaboration matters — that Harman can and should be more than the sum of its parts. To promote that thinking, Paliwal has put in place a reward system that encourages teamwork. At the highest level of the company, executives’ bonuses are tied 100 percent to the overall performance of the company. At the business unit level, half of executives’ variable pay is tied to their division’s performance, and half is based on overall company performance. At lower levels, incentive compensation is more closely linked to individual performance because, as Paliwal notes, there is little these employees can do to directly influence overall company revenues and profits.

Paliwal knows there are some detractors of this approach, because the topic will come up during annual meetings of the top 150 leaders of the company. “I will not say that we have mastered it,” Paliwal said. “You learn during cocktail hours that there are some nonbelievers. Once people are a little comfortable, they will start to say, ‘I busted my rear end and I see someone next to me benefiting from that.’”

At that point, Paliwal reminds them that there are inevitable ups and downs over the long term, and that perhaps three years ago they benefited because one of their colleagues was performing better than they were. “I’m not saying we’re democratic, and that everybody should be compensated in the same way,” Paliwal says. “I am saying that individuals don’t win, and that corporations are a team sport.”

This broad focus on the team mind-set also drives the compensation strategy at Archer Daniels Midland (ADM), the Chicago-based food processing and commodities trader, according to Michael D'Ambrose, the company's chief human resources officer. Three-quarters of the bonus of every manager, down to frontline supervisors, is based on company-wide metrics, with the other quarter based on individual goals.

"When I describe the culture at ADM, I talk about a place where people are so committed to the performance of the person next to them that we don't let people fail," D'Ambrose says. "We have one single bonus strategy that reinforces that behavior to help make everyone successful. It's about team success. It's about recognizing that if the person next to me isn't a success, then I'm not going to be successful, so I can't let them fail."

Accountability without blame

The most traditional form of incentive in business is to give an individual an ambitious goal and tie his or her compensation to it. The thinking behind this approach is that having so much at stake will inspire greater effort to achieve the goal. This, after all, is the bedrock principle of compensation plans. Results matter. Investors demand them. The board and leadership team feel direct pressure to deliver.

Marcus Ryu, CEO of Guidewire Software, which makes software for the insurance industry and is based in Foster City, Calif., studied philosophy in graduate school at the University of Oxford. A core tenet of his company is "no wishful thinking." He believes that overly optimistic expectations can have damaging effects on culture. "There are many cultures where, if the outcome doesn't happen as you wish, then somebody has to be held to account, and that means someone has to be blamed and sacrificed," he says. "But then what happens? It creates all kinds of unintended consequences, because people don't want to be associated with a risky problem. They become more risk-averse or allocate more of their energies to making sure that they get associated with positive stuff."

> **"If the person next to me isn't a success, then I'm not going to be successful, so I can't let them fail."**

The answer at Guidewire is to establish a culture that embraces a seeming paradox of accountability without blame. Accountability, as Ryu defines it, means that you have committed yourself to an outcome and that you will do everything that's professionally within your power to achieve it. "But the world's a complex and uncertain place, and so things may not work out for lots of reasons," he says. "A lot of organizations will say to a salesperson, 'If you make your number, you're a hero. If you don't make your number, you're a loser.' That ignores the fact that a lot of sales is random, and that you have a finite ability to change the appetite to buy.

Companies are rethinking their focus on numerical performance targets.

"In those situations, you have a compensation model that's linked to that sales target, but you end up paying a huge price in [terms of] people's collaboration, their willingness to take risks, their loyalty to an organization," he adds. "You do get clarity from simple targets and they are objective, but it comes at a terrible price, in my view."

A large portion of incentive compensation at Guidewire is tied to company outcomes, with the rest linked to team and individual outcomes. But the individual judgment is generally evaluated on an effort basis. "It's about not making individuals or teams bear the variance that the world brings and suffer the consequences of randomness that's beyond their power," Ryu says. "You have to insulate people from that while saying, 'We're going to do everything within our power to achieve our goals.'" Guidewire's approach seems to be paying off. Since the company went public in 2012, its stock has risen more than 450 percent.

Rethinking formulas

Many forces help shape a company's culture — including its size, industry, leaders, and relative health. There is no one-size-fits-all compensation formula and promotion protocol for rewarding behaviors as well as performance. But the examples above suggest that more companies are rethinking their focus on numerical performance targets and adopting a multidimensional approach to rewarding people who embody the organization's stated values. That should prompt more compensation committees and HR leaders to raise new questions about the packages they approve, the promotions they endorse, and the desired cultures they seek to help management create. In essence, having a successful compensation plan is about closing the gap between what is said and what is rewarded so that leaders "walk the walk" and send unmistakable signals about what matters in terms of behaviors.

For directors, leadership teams, and senior HR executives, three potential lenses can be used to evaluate executives, and these lenses reflect the three categories of a *how*-focused incentive formula. The balance among them can be adjusted to suit a particular strategy and philosophy, and the mix can be shifted for different levels of seniority.

Lens One: Key performance indicators. Are your employees hitting their individual financial performance targets, and are they doing so in a manner that brings the teams they are leading along with them? Are their direct reports engaged, together with everyone in their business unit? Are high performers staying or leaving? For most organizations, this should be the table-stakes conversation around a leader's baseline performance.

Lens Two: The "wake" of leadership, positive or negative. Is the whole organization prospering? This can be measured through collaboration across the matrix, contributions to projects outside one's direct remit, development of top talent for other parts of the organization, and additional metrics essential to executing a company's strategy rather than simply delivering the basic financial results associated with one's role.

Lens Three: Future potential. Do the behaviors and mind-set exhibited by the leader model those the company has determined will be vital to lead in the next evolution of its strategy? Examples of this approach are still rare, but based on our consulting work with large multinational clients, we believe it is the next phase of compensation strategies. Whether the future strategies require leaders to learn faster, be more inclusive, or integrate technology more quickly, including those traits in compensation and succession ensures that people pay attention to them — and are rewarded for them.

To be clear, a leader might be top-notch when viewed through Lens One and Two — and receive this year's annual bonus accordingly. But if he or she comes up short when viewed through Lens Three, it might signal that he or she doesn't deserve a promotion or long-term incentives. There is subtlety and complexity here, yet when leadership skills — for both the present and the future — are factored into bonuses, long-term compensation, and promotions, the importance of culture created through such mechanisms moves from the margins to the center. As Peter Drucker wrote: "What gets measured gets managed."

There is an opportunity for chairs of compensation committees to come together with human resources officers and chief executives to rethink how to develop incentives that will help them engineer the culture they want. "It's not just about the numbers," says Shellye Archambeau, the former CEO of MetricStream, who is now a director on boards that include Verizon Communications and Nordstrom. "How did we get there? The culture is in the how; it's not in the performance or the results." +

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