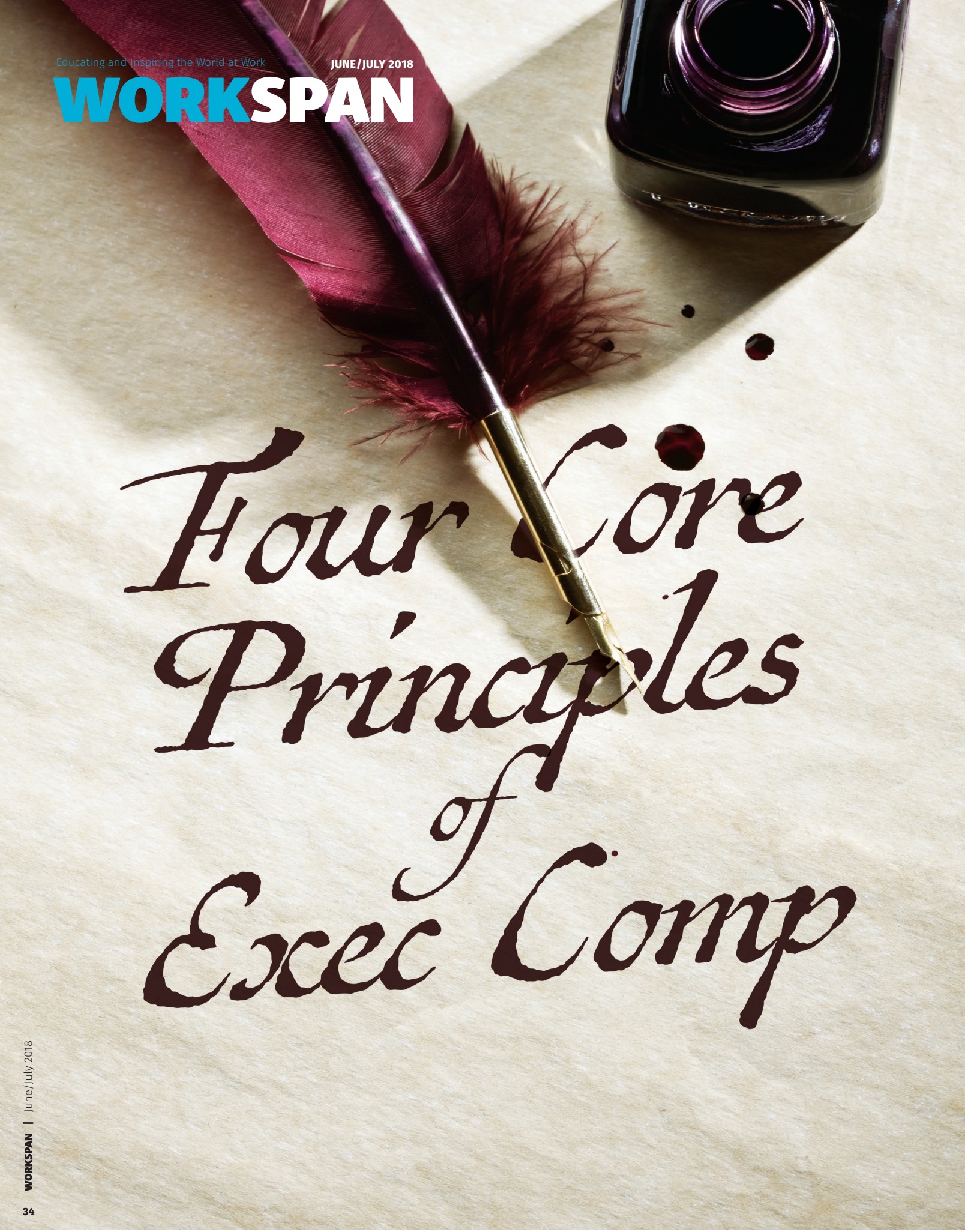
Educating and Inspiring the World at Work
JUNE/JULY 2018
WORKSPAN



Four Core Principles of Exec Comp

Connecting Purpose, Strategy and Incentives

Executive compensation is still a relatively young profession and field of study. As it has matured, core principles have started to coalesce. Principles are important because they give executive compensation professionals a consistent, common framework for serving the best interests of their organizations. (See "Professions Strive for Excellence and Integrity.")

Executive compensation principles and standards have evolved through the efforts of many professional bodies including the Business Roundtable, the National Association of Corporate Directors, the Conference Board, the Aspen Institute and the Center for Executive Compensation, among others. This work is complemented by other organizations that have developed principles for corporate governance, which often touch on executive compensation.

BY DON DELVES, ED.D., CPA, WILLIS TOWERS WATSON

Four Core Principles of Exec Comp

Four Core Principles

A few years ago, an in-depth research study was conducted to develop a definitive and comprehensive set of principles for executive compensation. This was a multi-step process that:

- Gathered and studied various proposals for executive compensation principles, all with similar core elements
- Asked more than 200 board members which principles and concepts they thought were most important
- Studied academic literature on the history of executive compensation and some of the key theories underlying the field, including agency theory and behavioral economics.

With this as a sound starting point, 14 prominent board members gathered to participate in a process called the Delphi Method for narrowing a broad group of principles down to a core group of overarching principles. The intent was to end up with a simple but powerful construct that captures the myriad goals attainable through executive compensation. The resulting principles are intended to provide a contextual framework and a nontechnical language for discussing, debating and making decisions about executive pay.

A fairly lengthy list of possible principles met the definition of a principle (see "A Principle Defined").

Based upon panel responses, it was apparent that four principles were deemed especially important: purpose, alignment, accountability and engagement. Several participants suggested that the other principles presented were elements of these primary principles, and there also was some consensus that fewer principles would be preferable and more useful for focusing board attention and decision-making.

These four overarching principles are:

- **Purpose:** Captures why the corporation exists, its mission with its various constituents, and its strategy and objectives. Purpose is the highest level of abstraction in corporate governance, incorporating the core governing questions that guide an enterprise. Purpose answers the questions: Aligned with what? Engaged toward what? Accountable for what? Purpose, in our definition, includes mission, vision, strategy and objectives.
- **Alignment:** Captures the essence of agency theory by ensuring that management is aligned with and acting in the best interests of shareholders, and possibly other stakeholders. Alignment is a unifying principle, tying together the purpose, mission, strategy and objectives of the company with the interests of shareholders, and using compensation as part of the system that creates and enforces this alignment of interests.

Professions Strive for Excellence and Integrity

Professional disciplines such as medicine, accounting, actuarial science and law are among the practices that have developed core guiding principles and standards of practice that are essential to ethical excellence. These standards and principles include:

- **Medicine**: The four core principles of bioethics (nonmaleficence [i.e., first, do no harm], autonomy, beneficence and justice) complement other standards of professionalism that have developed through the centuries, such as the Hippocratic Oath.
- **Accounting**: Initial principles of relevance, reliability, usefulness, comparability, materiality, and costs vs. benefits were formalized with the creation of the Financial Accounting Standards Board in 1973.
- **Actuarial science**: The American Academy of Actuaries' "Retirement for the AGES" initiative provides a framework based on fundamental principles of alignment, governance, efficiency and sustainability.
- **Law**: The American Bar Association's Model Rules of Professional Conduct and the Code of Judicial Conduct.

A Principle Defined

A principle is defined as:

- A simple yet profound concept that is easily recognizable but highly expansive in its interpretation and application (e.g., accountability, commitment independence, stewardship)
- A powerful leadership tool that, when properly used, encourages individuals, groups and organizations to naturally gravitate to it
- Not a rule, prescription or guideline, but rather one or two words that exclude "should" or "must."

- **Accountability:** Management is accountable to the board which, in turn, is accountable to shareholders and possibly other stakeholders. Employees are accountable to management. Management uses accountability as a primary tool for running the company, including setting objectives, directing behavior, assessing performance and determining rewards and consequences. Compensation is a key element of accountability at all levels.
- **Engagement:** Captures human motivation and the psychological implications of behavioral economics and self-determination theory, which explore what motivates people's choices. Engagement captures the core elements and objectives of compensation at all levels in an organization: motivating people, directing their behaviors, attracting them to the company, ensuring their retention and creating differentiation based on performance, responsibility, competence and experience.

Relationships Among Primary Principles

The four primary principles capture and represent four significantly different — but related — aspects of executive compensation governance. The relationship among the principles (Figure 1) emerged from a series of discussions of the principles with key board members that we noted earlier.

At the highest level, *purpose* defines why the corporation exists and toward what end or ends it operates. It is difficult, if not impossible, to operate by any of the other principles without knowing why, or toward what end, the firm is operating. Purpose should be the core focus of the board of directors.

Alignment is the principle that ties together purpose, accountability and engagement. It creates connections and balance among the other principles. It helps ensure that there is congruence and synchronization among (a) why the firm exists, (b) how the company is managed and (c) what its people are motivated and paid to do.

Accountability is primarily the domain of management. It incorporates the systems, structures, goals, objectives, checks, balances, rewards, consequences, reporting and disclosure that are essential to the effective operation of any business. Accountability provides the assurance that management and employees are taking the actions and producing the results they have promised and that are in the best interest of shareholders and other constituents.

Engagement affects all employees. It is what compensation is all about in terms of day-to-day functioning and operations, and it fosters action and commitment in people across the organization toward a purpose and objectives.

Increasing Importance of Purpose

While these principles should be timeless, they have particular relevance today. Earlier this year, BlackRock CEO Laurence Fink wrote in his annual letter to CEOs that companies must more clearly define their purpose and strategy to ensure long-term viability and sustainability. This is reflected in the principles of purpose and alignment. A key

Figure 1 | How the Four Primary Principles Connect

Executive Compensation Governance Principles and Their Key Elements

Principle	Elements
Purpose	Mission Vision Values Strategy Objectives
Alignment	Connection Balance Congruence Synchronization Inclusion
Accountability	Effectiveness Efficiency Affordability Line of sight Objectivity Integrity Fairness Consistency Clarity Transparency
Engagement	Motivation Direction Attraction Retention Differentiation

Four Core Principles of Exec Comp

function of executive compensation is to align the interests of management and owners. BlackRock, an owner of virtually all publicly traded companies, is saying that the interests of its investors are best served when a company focuses on purpose and strategy, thereby enhancing long-term, sustainable shareholder value.

This may mean that investors like BlackRock will expect companies to be clearer about their purpose, mission, vision, strategy and objectives. Investors may want companies to demonstrate Grant had a clear connection between stated purpose and strategy, and executive compensation plans.

Fink's letter is the most recent missive in an ongoing debate about why corporations exist, who really owns them and whose interests should be served by management. Some argue that corporations exist solely to maximize profits and long-term value for shareholders, who are the owners. Others maintain that corporations serve multiple constituencies, including customers, employees, communities and the environment. Some argue that companies must have a social purpose and serve broader society if they are to thrive, innovate and be sustainable for the long term. Only by fulfilling these goals will long-term value be maximized, according to this latter viewpoint.

Articulate Purpose, Measure and Compensate

The preceding paragraph greatly simplifies the debate about corporate purpose and ownership. And it is not necessarily incumbent on executive compensation professionals to have a stake in this debate. However, it is important that we, as professionals, know where the leadership of the organizations we serve stand on the purpose of their organization and the constituents they serve. Executive compensation professionals can help leadership best articulate their organization's purpose and strategy, figure how to best measure success in achieving that strategy and build those measures into effective compensation and incentive programs.

The question of purpose is sometimes more pronounced and important at privately owned companies, where the owners are individuals, families or a specific investor or fund. The owners' views on purpose, mission and strategy may be very specific. They likely have specific views on growth, reinvestment, cash flow, risk, leverage, time horizon, the importance of value vs. cash flow and more. They also may have specific views on the corporation's role in the community, as a steward of the environment, as an employer and for its customers.

Principles that Define Executive Compensation

The principles of accountability and engagement further define our job as executive compensation professionals.

Executive compensation is part of the core accountability structure in most organizations. As the adage says, "What gets measured gets managed," and compensation systems are one of the most powerful ways a company measures and rewards performance. It is our job to ensure performance is measured well and accurately, goals and ranges are set at the right levels, adjustments are few and appropriate, and payouts truly reflect relative performance. This may be the most difficult part of our jobs as compensation professionals.

Engagement captures our roles of both psychologist and statistician. Compensation plans must be clear, understandable and well communicated. Executives should have a clear line of sight to what is being measured, meaning that their actions affect the results. Incentives should foster the right level of cooperation and teamwork, encourage innovation, and be highly motivational. And, of course, the whole program must be competitive with market practices.

Initially, the principles were designed to capture everything that a board member must consider and weigh when making executive compensation decisions. However, they also do an excellent job of capturing our jobs as executive compensation professionals. WS

Don Delves, Ed.D., CPA, is a managing director of executive compensation for Willis Towers Watson's rewards line of business. He can be reached at *donald.delves@willistowerswatson.com* or *312-873-5054*.