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A White Paper

BUSINESS ENVIRONMENTAL IMPACT THE BUSINESS POWER COALITION

The external business environment has an enormous influence over organizations in general, and specifically in the development of executive reward strategies. We've broken the environmental category into two coalitions: the general business power coalition, and the company specific power coalition. The general business environmental coalition can be further broken into four categories: the public, government and government agencies, competitors, and employee associations and unions. Each of these groups has an amazing influence when it comes to the development of an organization's total reward strategy. This paper discusses the four categories of the general business power coalition.

FROM FOOTBALL FIELDS TO FOOSBALL TABLES

The public, government/government agencies, and employee associations/unions—have one thing in common, have one thing in common, when it comes to executive total reward strategies: they effectively define the playing field by determining what is out of bounds. More often than not what these groups find wrong is generally wrong. And then the media gets a hold of it. Sometimes an organization is so intent on staying out of the headlines that it inappropriately shortens the playing field for their own executive rewards, and that can in a failure to optimize their executive reward resources. These companies are guided by what everyone else is doing, instead of developing a reward strategy that is designed to drive their business strategy. There are three cardinal sins when developing executive reward strategies.

THE THREE CARDINAL SINS

Sin #1: Mismanaging the “money”: Executives want to stay out of the headlines so companies often end up with a “default strategy” of positioning everyone at a percentage of the competitive market.

Sin #2: Managing to average: To compound sin #1, they often position the mix of reward components to reflect the mix most often found in the marketplace. They’ll just do what the other guy is doing.

Sin #3: Muddling the messages: The third mistake is in the development of the messages delivered by the reward program. Using other companies programs to justify decisions is not leadership.

THE PUBLIC

First of all, let’s clarify what comprises the general public. It’s media, newspaper editorialists, and people (priests, teachers, friends, neighbors, spouses, children, etc).

Most executives will go to great lengths to preserve a positive public impression or image. But, the fact remains that most outcomes from executive reward strategies—let’s say about 90%--are not going to whip the general public into congressman-writing frenzy. It’s the ten percent or so of companies who do have reward strategies that warrant public outcry that land on the front pages of the newspaper or on the evening news. It’s good to stay out of the headlines. But you don’t want to get so hung up on avoiding bad publicity that you shortchange your reward strategy. Listen to what the public says, but don’t go overboard.

YOU DON’T NEED A WEATHERMAN TO KNOW WHICH WAY THE WIND BLOWS

When legislators attempt to perform social engineering using the tax code or other regulatory system, the results aren’t always as intended. Let’s take a quick trip through recent history:

- Bill Clinton’s attempt to curb soaring executive paychecks by limiting deductibility resulted in a situation today where \$1 million is considered the minimum base pay of any CEO.

- Sarbanes-Oxley (SOX) was designed to improve the quality of corporate governance in the wake of Enron and other scandals. SOX showed that potential conflicts of interest between executives and shareholders would be managed. And, it sends a clear message that politicians aren't afraid to act if executive behavior becomes excessive.
- IRS Section 409A was supposed to clear up the approach of deferring compensation. This little piece of legislation and the resulting 400 pages of regulations have had a big change to deferred compensation programs.
- Democratic Leaders of the House have recently introduced "The Protection Against Executive Compensation Abuse Act." The Act would require companies to include an executive compensation plan on the ballot for shareholder approval. It would also require shareholder approval of golden parachutes, and require simple and clear disclosure of compensation arrangements on the company web site.

Legislators certainly affect how companies structure their executive reward strategies. Highly influenced by public opinion, legislators aren't afraid to send the message that executive high jinx won't be tolerated on their watch.

RULES, RULES AND MORE RULES

The IRS, the SEC, and others have done a remarkable job given the complexity and the dynamic nature of business enterprise today. However, the outcome of their efforts have contributed to the complexity associated with executive compensation today.

The SEC's final disclosure rules run 436 pages to instruct companies how to file their proxies to disclose compensation info about your CEO, CFO, and three other highest-paid executives, along with information about the members of the Board of Directors. But despite its complexities, the SEC has finally brought some leverage to the issues of executive compensation disclosures and that is a good thing.

Beginning January 1, 2007 companies must comply with FAS 123R, the Financial Accounting Standards Board Rule that mandates companies with calendar year ends expense their stock options. To date, the complexities involved with complying with the standard have caused many companies to simplify their stock option-grant policies.

Clearly government agencies can have a huge impact on total reward strategies.

GOVERNMENT JUDICIARY GROUPS

Executives have developed a new sense of awareness of the implications associated with their rewards and the effort of the judiciary branch to address transgressions. There's no doubt that judiciary groups are one more environmental factor that has an impact on an organization's total reward strategy.

EMPLOYEE ASSOCIATIONS AND UNIONS

Employee unions are becoming increasingly active in trying to influence not only Board governance, but also executive reward program design. However, unions will probably not have significant influence over total reward strategies, except, perhaps, at the very boundaries of the issue. With scarce resources, unions may be better off deploying their resources in an effort to attain better governance by addressing Board of Director elections.

KEEP YOUR EYE ON THE COMPETITION

Competitors are a huge outside environmental factor when it comes to poaching good executives. The most dangerous competitors are those who are performing poorly and need your executives at just about any price. The better your company performs, the more your executives become a target for head-hunters – and not just in your industry either. This inflates the market for executives. In the competitive business environment factor, the key aspects are to appreciate the economics of the industry in general, and where, specifically, your firm stands.

SOME FINAL THOUGHTS

So now that you understand how each external environment group can influence not only your organization, but also your total reward strategies. You need to understand how the external environment defines what is "out of bounds" for businesses in general. But keep environmental elements in perspective. While this group of entities is influential in shaping the general dialogue of total reward strategy, with the exception of competitors, it really has very little specific impact on the reward strategy of a specific organization. Don't do something just because the other guys are doing it. Don't let the headlines cajole you into placing limitations on your strategy. And remember, the best reward strategies are those in which you stay within bounds, but play your whole field.