THE JOURNAL OF THE HUMAN RESOURCE PLANNING SOCIETY

Volume 31 Issue 2 2008

People & Strategy

SPECIAL CEO ISSUE

CEO INTERVIEW

How Coke's CEO Aligned Strategy and People to Re-Charge Growth: An Interview with Neville Isdell

Gregory Kesler

NEW PERSPECTIVES

Changing Your Company's Strategy? Better Change Its Personality, Too: The CEO-HR Executive Partnership

Dan Ciampa/George Stalk

NEW RESEARCH

Beyond the Boardroom: Considering CEO Pay in a Broader Context

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Three Keys to CEO Succession: Expectations, Choices, and Integration

Constance Dierickx/Juleen Veneziano

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The Human Resource Planning Society (**HRPS or the Society**) is a unique and dynamic association of more than 3,000 human resource and business executive members. They are committed to improving organizational performance by creating a global network of individuals to function as business partners in the application of strategic human resource management practices.

Now in its third decade of service, the Society is a vital force in addressing and providing current perspectives on complex and challenging human resource and business issues. HRPS is a non-profit organization representing a mix of leading-edge thinkers and practitioners in business, industry, consulting, and academia around the world.

The Society continuously seeks to build recognition from business leaders and the HR community for the critical role of HR as a strategic business partner in achieving higher levels of organizational success. In support of this mission, the Society:

- Serves as a global forum for presenting the latest thinking and information on the HR implications of key business issues and strategic HR practices.
- Offers a broad range of comprehensive publications and professional development programs with distinguished human resource scholars, practitioners, and business leaders.
- Builds networks of diverse individuals to exchange leading-edge HR ideas, information, and experiences.

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MARY ECKENROD, HRPS BOARD CHAIR, AND WALT CLEAVER, HRPS PRESIDENT & CEO, ANNOUNCE EXCITING CHANGES AHEAD FOR HRPS...

We are pleased to communicate to our HRPS colleagues some exciting news that will assuredly take our Society to the next level. After researching and exploring various options, we have selected SmithBucklin Corporation, an association management firm, to manage our organization and to build upon our firm foundation. Walt Cleaver will continue to serve HRPS as president & CEO, reporting directly to the board. Please visit *www.hrps.org* for more information on this important new direction for our Society.

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FROM THE EXECUTIVE EDITOR, Ed Gubman

I hope you saw HBO's superb series, "John Adams," based on David McCullough's magnificent book. Among the many things that stand out about Adams is his close relationship with his philosophical opposite, Thomas Jefferson. Adams stood for a stronger federal government to provide for the protection and needs of our citizens, whereas Jefferson believed in individual rights and something like continuing revolution to liberate human potential. The tension between these contrasting concepts continues to sustain our republic. It always strikes me that when we experience tough times in our country, the wisdom of the Founding Fathers is even more prescient.

Part of Adams' genius was his awareness that he needed to balance his own thinking with that of Jefferson. Though stubborn, grumpy, and vainglorious, Adams knew when to ask Jefferson for help—it was his idea to approach Jefferson to draft the Declaration of Independence, rather than do it himself. Through his difficult Presidency, Adams continued to seek the counsel of Vice-President Jefferson, even as Jefferson was actively campaigning against him.

What do Adams and Jefferson have to do with this special issue of *People & Strategy* on the CEO? Plenty, as it turns out. When we commission a special issue, we do not start with a preconceived viewpoint. We start with curiosity about a topic, then, just as CSI technicians follow the evidence, we follow the articles to draw our conclusions. The unmistakable conclusion from the superb series of articles you are about to read: The major part of the CEO role today is addressing the change imperative, and doing so requires a broad perspective, reconciling varying viewpoints from a variety of stakeholders. Ultimately the CEO must make the decisions and set the direction; the successful ones do so based on often-conflicting inputs. Just as Adams did, they seek out their Jefferson to create a deep, richly textured understanding of their situations, then they move forward.

I want to salute Greg Kesler, our editor for the talent management knowledge area, who did an amazing job as special editor for this issue. Greg solicited many of the articles directly, and shaped and edited all of the pieces to create this issue. He also conducted and wrote the insightful interview with Neville Isdell, the transformational CEO of Coca-Cola. Putting this issue together was a lot of time and hard work, and Greg has a thriving consulting practice, so he already had a full plate. On behalf of the Society and all our readers, thanks a lot, Greg, and congratulations.

Our current age is awash in information, including books to read. What we lack is time. To help you make better decisions about how to use your precious reading time, we are introducing a new and improved book review section, which continues to be edited by James Dulebohn. You will find more, briefer reviews, with clearer ratings and recommendations about what books to read. Please let us know how you like the new section at *info@hrps.org*.

Happy Reading,

Ed Gubman
Executive Editor, *People & Strategy*

FROM THE SPECIAL CEO ISSUE EDITOR

Why CEOs Succeed

This is a great time to take a break from scary financial headlines and reflect on how value is created. Our special issue of *People & Strategy* is focused on the role of today's CEO. We set out to find some fresh research- and experience-based thinking about how that role has evolved in recent years, especially in terms of leading people, values, and culture to greater results. We do not claim to define the "new role of the CEO," but some clear themes are at work across the articles in this issue, all of which were written especially for our journal.

Perhaps dominant among those themes is the change-leadership imperative at the center of the chief executive's workday. In our first feature article, an interview with Coke's Neville Isdell, he recounts his role as turnaround, change leader over the past four years at the troubled brand builder. Isdell is one of the most intuitive CEOs we know when it comes to pulling the HR levers to drive change across a large system.

As if to elaborate on or react to Isdell's interview, Dan Ciampa and George Stalk look into the partnership between the CEO and the top HR officer. If ever there was a partnership between a chief executive and his HR executive, Coke's Isdell and Cynthia McCague (an American with many years of international assignments) have it. Their relationship began in the turnaround of central Europe's large Coke bottling company. They worked out "chops" together in London, Vienna, and Athens. Portions of that opus were transferable later to the big top. Some lessons were not, and the two were largely working without a road map at Coke over the past four years.

Ciampa and Stalk make the case in their article that CEOs should lead as if they are in a continuous turnaround. They argue for practical initiatives, co-led by the CEO and HR executive, to align strategy and culture. Stalk's many years as a strategy consultant at BCG have taught the fruitlessness of elegant strategies that are not understood, owned, and acted out in the behaviors of leaders.

Later in the journal, David Dotlich, Peter Cairo, and Stephen Rhinesmith point out the blindspots of long-time insiders who may not see the sudden shifts in front of them, and who may avoid the risky paths. Dotlich and company argue for a holistic view of the characteristics for building and buying great CEOs. Consider their case for finding the right stuff—in the head, heart, and guts of the leader.

Coke's Isdell had the benefit of spending years outside Coke in some of its large international bottling franchises. Upon his arrival in the top job at Coke, out of retirement (from a large bottling company), he had little to lose and was not concerned about taking the safe path. Consider his confrontation with some large bottling partners over legacy contracts that would limit new product and distribution innovations. Internal to Coke, he challenged the "think local, act local" culture and the assumption that country and geographic division presidents were kings over their own domains. Having said that, he demonstrated (with his head and his heart) wisdom in building coalitions to make change, armed with a deep understanding of how to get things done in the daunting 300,000-person Coke system.

After watching the global versus local pendulum swing back and forth a number of times, Isdell created better operating governance with his "freedom in a framework" model. Coke hopes to gain more speed and innovation, but it also wants to leverage worldwide resources like R&D investment. And it wants leader behaviors lined up around its "manifesto for growth."

Why did Nardelli fail at Home Depot, and where did Jim Donald go wrong at Starbuck's, although Isdell appears likely to be known as the guy who turned Coke around? In this issue, Dotlich and colleagues argue that the holistic success profile we should seek in CEOs is rooted in a leader's "view of the world." Isdell's view was probably shaped by his many expatriate lives and a humility that is part of who he is.

Sandwiched between these articles is a piece by Steven Van Putten and Aubrey Bout on CEO pay that brings some fact-based insight to the controversy of CEO compensation. Although these authors believe most boards manage their CEO-pay responsibilities well, they call out the damage of excessive senior leader pay on a company. They make a case that boards should consider the legitimate needs of four internal and external stakeholder groups in deciding not only total compensation paid, but the manner in which it is structured.

Juxtaposed with our other leadership thought pieces in this *People & Strategy* issue, Van Putten and Bout's argument comes to life: A CEO's own efforts to communicate—to influence culture and leader behaviors—will ultimately be colored by the structure of her own pay package as well as those of the senior leaders around her. The authors bring research to the table that once again makes it clear that pay at risk for a broad base of employees helps drive higher business performance. Their summary of best practices sketches a road map to design incentives that help energize the kind of change agenda our thought leaders outline here in our journal.

Dierickx and Veneziano mine their research and experience in CEO succession to share insights from the boardroom about engineering the overall succession process. Once the development work has been done or external candidates have been sourced, or both, by what process do boards create a clear set of expectations for the successor's role? How do they guide the assessment and selection process? How do they remain engaged to be certain a smooth transition takes place?

Looking deeper, consider succession in the context of the corporate governance failures we have watched unfold in the past six months in financial companies. The frenzy of complex and opaque debt instruments that provided the icing on the current financial collapse goes well beyond sub-prime mortgages. Jack Welch and others have surmised that in creating new and now failed derivatives products "the financial engineers understood what they were creating, but their managers . . . and their managers' managers, all the way to board level, probably didn't" (*Business Week*, March 24, 2008).

Chief executive success rates in global companies are lower than they should be because the succession process is often too little too late. Boards are still not investing enough quality time to understand the depth of the bench three or five years before a CEO replacement is needed. Presentations intended to inform boards on leadership bench dynamics are often superficial and the deep dive into the data and the plans may not happen. Strategies for closing the bench gaps are thin and short on the hard work of developing senior executives. There are terrific exceptions to this now, but more is needed, and it starts with corporate governance. Boards do a service to CEOs when they make it clear they expect to see evidence that more potential candidates are growing into senior leaders, two or more levels below the CEO, and when they remain engaged in some of those (and other) details.

Anna Tavis, our "Perspectives" editor, stirs things up in this issue with Ross Zimmerman's thoughts on analyzing a company's return on executive pay. The counterpoint comments from a top HR executive, an academic, and a few consultants bring insight as well as fuel to the conflagration.

Change is the work of the CEO today. Whether Neville Isdell pushed his beloved, brand company hard enough and far enough for the long haul is to be seen. In any case, we hope you find some new insights in this issue of the new *People and Strategy.* I'm grateful to Neville Isdell and to all of our authors for their contributions to this issue. And thanks to Ed Gubman, our executive editor, for his challenging support through the project.

Gregory Kesler
Editor, CEO Special Issue
Editor, Talent Section
People & Strategy

Point/Counterpoint

One cannot discuss the role of the CEO without talking about what and how they get paid. Though at HRPS we usually leave that to other professional associations, we know many of our members are involved with issues of executive compensation, from working with boards to determine pay levels to worrying about the impacts of executive pay on employee engagement. In this issue we take two looks at executive pay, here in the Point/Counterpoint and later in an excellent article by Steven Van Putten and Aubrey Bout. This Point/Counterpoint leads with a new way of measuring CEO pay effectiveness by Ross Zimmerman of Exequity, LLC. A diverse group of commentators weigh in on Ross' methodology and recommendations, as well as other key aspects of CEO pay.

POINT

Are You Getting A Bang Out of Your Executive Pay Buck?

Ross Zimmerman
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Executive pay is so complex that all parties involved struggle to establish a clean way of discerning whether an executive team is being fairly or extravagantly rewarded. One would think that this would be easier, particularly with the intense focus on the issue from all sides.

Adding to the confusion are the many different ways in which executive pay is disclosed, measured, and critiqued. The press tends to sensationalize executive pay by spotlighting individual extremes, and exacerbating these extremes by adding together the elements of pay that imply the most egregious waste of corporate money. Executive pay critics tend to sniff out the pay practices that they see as most incendiary, and hold the recipients of this largesse up to public ridicule. Companies often anticipate and respond to this dynamic by employing opaque disclosures to throw the critics off the scent.

The government has jumped into the fray with Goliath-sized boots, regulating executive pay from a variety of angles. The regulations have come with mixed results: in some cases, adding clarity through transparency of executive pay disclosures, and in others adding fuel to the fire of escalating pay levels.

Most agree that the governmental actions that have been imposed with the legislative agenda of restricting executive pay—for example, the tax limits on the deductibility of executive pay over one million dollars and the golden parachute excise tax rules—have backfired by provoking companies to make pay changes that have contributed to substantial increases in executive pay. On the other hand, regulations that have focused on the transparency of executive pay (through public disclosure of pay levels and programs) are generally agreed to have helped constrain pay levels.

The jury is still out on the impact of the most recent changes to the proxy disclosure rules. These rules, applicable for the first time in 2007, seek to require companies to provide greater clarity of complex executive pay arrangements. Although the mandated uniformity in tabular and narrative disclosure has enhanced the understandability of many elements of companies' executive pay programs, the sheer volume of the disclosures has frustrated many proxy readers. Further, the reliance on disclosure of accounting charges associated with long-term incentive awards and the blending of disclosures related to various incentive arrangements have muddied the picture for many.

So how does one gain a better insight into whether an executive team is effectively shepherding a company toward enhanced shareholder value? We believe that the best measure of an executive team's effectiveness is the company's executive pay spend—the total value made available to the executives in a given period of time—not a blend of multiyear accounting charges attributed to incentive vehicles together with true dollars delivered, such as is front-lined in the summary compensation table (SCT) of the proxy disclosures. If pay-for-performance is the ultimate benchmark of executive pay effectiveness, then the most pertinent focus is a comparison of the true dollar value made available to executives in relation to the company's increase in total shareholder value.

Just as companies often judge the effectiveness of operational leaders based on the returns generated versus the investment in creating those returns, we believe that top executives should be evaluated by comparing their contribution to shareholder value in light of the money spent paying the executives. We at Exequity call this metric the company's "return on executives," or ROX, for short.

An Overview of the ROX Index

At the core of the ROX index is a summation of value made available to executives by the company. Some elements of pay are easy to tally in this regard: base pay, bonuses earned, and long-term incentives that are earned during the test period. We add these into the mix regardless of whether the amounts are deferred, as our focus is the value credited to executives within the period.

In the case of equity-based awards, we include two aspects of incentive value:

1. The actual value reaped by an executive during the period. In the case of stock options, this value consists of in-the-money gains associated with options that are exercised during the period. In the case of restricted stock and performance shares, this is the full value of awards that vested during the period.
2. To this we add the appreciation (or depreciation) in value attributable to awards that were not exercised (in the case of options) or did not vest (in the case of restricted stock and performance shares) during the period.

This focus on actual value delivered (and/or accruing) to executives highlights the true value transfer from the company's shareholders to executives. This represents an important distinction from the disclosures in the summary compensation table of the proxy, as the SCT showcases the accounting charge attributable to all unvested long-term incentives that are outstanding (not just those that delivered actual value to the executives). By focusing on the accounting charge, the disclosure fails to capture true dollar value transferred to the executives, and instead portrays the *expected* value (often measured solely at the grant of the award) accruing to the executives.

Other tables in the proxy reveal the true value received by the executives during the year (e.g., the "Options Exercised

and Stock Vested" table), but the reader is required to extract these disclosures and add them to the base pay and incentive numbers provided elsewhere in the proxy. In truth, the new proxy rules obscure one of the most important contributors to executive pay: the annual appreciation in unexercised options held by executives. In order to make sense out of option appreciation the proxy reader is required to make a number of calculations on all outstanding option tranches and compare these calculations to similar math applied to options outstanding in the prior year.

We believe that the executive pay spend is best understood by deriving the value that becomes available to an executive in a given period, where that value was not paid-for by the executive. This truly represents the wealth accumulation to the executive and the corresponding opportunity cost incurred by the company in directing money to executives as compensation instead of to shareholders as stock price gains or dividends.

In our view, determining the total company spend on the executive team is half the battle in understanding whether the company is getting the best bang for its executive pay buck. The other half of the equation is the company value created (or destroyed) under the executive team's stewardship. This one is easy: We merely measure the total shareholder return during the period, that is, the summation of stock price appreciation and dividends distributed during the measurement period (see Exhibit 1).

The ROX score of a company helps provide a comparative metric that can be used to evaluate the efficiency of a company's cost of delivering executive pay, through all pay vehicles offered. Just as a company's return on capital can be used to gain a better understanding of returns in relation to investment in capital, ROX can be used to gain insight into the return on the company's investment in its leaders.

We believe that the ROX score of an executive team is a better metric than is a narrow focus on sheer amount of pay delivered to executives. By comparing total value accruing to executives in relation to increases in company value, we can assess whether the company's results have merited the pay.

Everyone understands that if a company wants to secure the services of an executive team that has the potential to perform like a Mercedes Benz, it cannot spend as if it were buying a Yugo. The ROX index provides a convenient barometer to determine whether the executive team the company has cultivated is justifying the company's investment through its executive pay programs.

In addition to helping the compensation committee calibrate pay levels versus its peers and establish the right mix of pay, the ROX score can help provide further insight for making incentive award decisions in the context of the executive team's

EXHIBIT 1

Determination of ROX Score

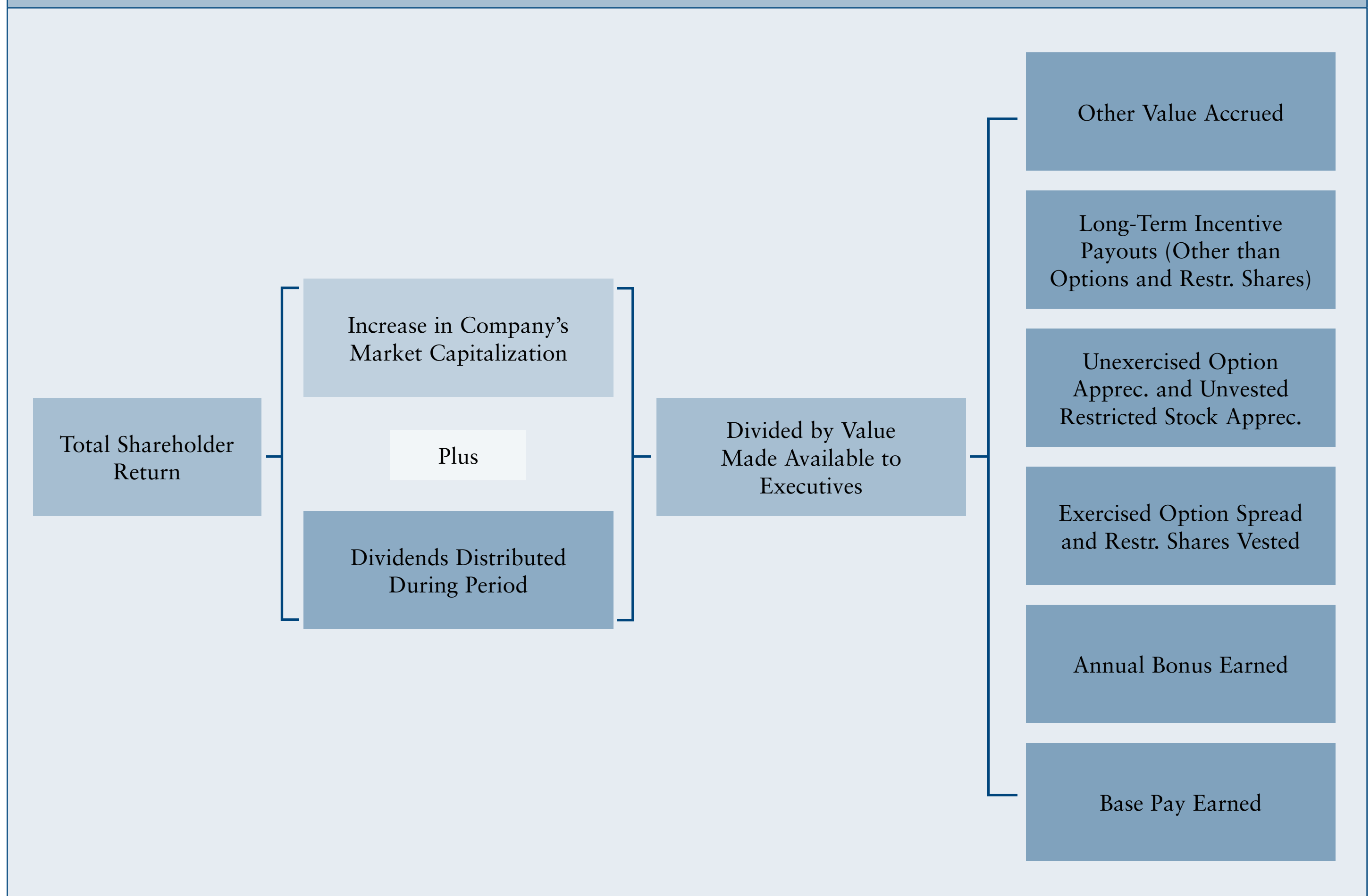

EXHIBIT 2

ROX Scores for Companies of Varying Sizes

Company Size	*Highest CEO ROX Score*	*Median CEO ROX Score*	*Lowest CEO ROX Score*
Large Cap	$24,665	$633	$119
Mid Cap	$2,586	$73	$13
Small Cap	$659	$66	$17

overall wealth accumulation. There have been increasing calls for executives' wealth accumulation to be incorporated into the determination of incentive award design and pay levels. By evaluating an executive team's past ROX performance, the committee can make judgments about the past effectiveness of reward structures, and can recalibrate the pay mix and design to better correlate pay delivery and company performance.

A strong ROX score also provides support for a company that has been criticized for the overall pay delivered to its executive team. One of the most surprising findings from Exequity's review of ROX scores is that some of the highest returns for each dollar of executive pay delivered were garnered by companies whose top executives have been heavily criticized for executive pay bloat. In our view, the best defense to the allegation that executives have been overpaid is evidence that the executive team has delivered greater company value for each dollar spent on executive pay than have executive teams that received lower overall pay.

Findings of Exequity's Review of ROX Scores of Leading Companies

Exequity reviewed the executive pay packages and company performance of the top 20 S&P companies, based on 2007 proxy filings. The results of the study were surprising in that many companies that received sharp criticism for their executive pay practices actually delivered far better returns on their executive pay spend than did companies that received acclaim for the moderation of their executive pay packages. Before we present the findings of the ROX study, a couple of cautions are important:

1. The ROX scores represent only one year of pay and company performance (2006, as reflected in 2007 proxies). This one-year focus was necessary because the new proxy rules first applied in 2007, so earlier-year comparisons are made challenging by the different disclosure frameworks in prior years. As additional proxy years unfold, multiyear ROX performance can be monitored so that the current relationships between executive pay and company performance can be reviewed in a broader context.
2. ROX scores are generally positively correlated with company size. It is important to make comparisons between companies of similar size. Similarly, given the unique market forces that can affect companies within a specific industry sector, it is important to exercise caution in drawing conclusions when comparing companies in different industries.

The correlation between company size and shareholder returns under an executive team is demonstrated by the comparative ROX scores of the CEOs of S&P large cap, mid cap, and small cap companies (the numbers in Exhibit 2 represent the total shareholder value gains for each dollar spent on the CEO's pay during the year).

The ROX scores of executive teams presiding over the 20 largest S&P 500 companies are noted in Exhibit 3 (the ROX scores appearing in Exhibit 3 reflect the return on the executive pay delivered to all of the top five executives, as opposed to the CEO-only ROX scores in Exhibit 2).

We find it interesting that three of the companies that received some of the heaviest criticism in 2007 for their executive pay practices (Pfizer, ExxonMobil, and Verizon) actually delivered some of the greatest returns on their executive pay spend. This indicates to us that a narrow focus on amount of pay alone can lead to questionable conclusions about the appropriateness of a company's executive pay program. The compensation committees that preside over executive pay programs that become the subject of public attack may also have at their disposal effective (and easily determined) defenses against these criticisms.

Summary

The ROX index provides companies with a useful tool in evaluating the performance of the top executive team in relation to the total value made available to executives. Assessing executive performance in the context of total value delivered to the executive team adds insight into the cost efficiency of achieving shareholder value gains. The focus on executive pay efficiency yields some interesting results when applied to companies that have been criticized for the sheer volume of pay delivered to their executives.

Considering a ROX-based pay link not only for the top executive team but also for directors has merit. Introducing a focus on pay efficiency would result in executive and director pay that is positively correlated with both shareholder returns and containment of executive pay costs. In cases in which the ROX index is not used as part of the incentive structure, the index can be used as an apples-to-apples benchmark to help compare a company's executive pay costs and share performance to those of the company's competitors.

COUNTERPOINT

Getting Beyond Share Price: The Truer Measure of Corporate Value

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Author
Stock Options and the New Rules of Corporate Accountability

Reading Ross Zimmerman's article, "Are You Getting A Bang Out of Your Executive Pay Buck?," I found several points of common ground: the need for better methods to compare total executive pay to total performance; examining the total cost of management instead of limiting ourselves to how individual executives are paid; and the courage to rank companies according to how much they pay relative to how much performance they generate. I also find his assessment of how to calculate total

EXHIBIT 3

ROX Scores for Top 20 S&P Companies in 2006

Company	*Total FY '06 Comp from Summary Comp Table ($M)*	*Total "Real" Dollar Comp Cost (Value Made Available to Executives)*	*TSR in 2006 (%)*	*Increase in Total Shareholder Value ($B)*	*ROX Score (Shareholder Value Increase for Each Executive Comp Dollar)*
Pfizer	$37	$28	15%	$26	922
Google	$10	$15	11%	$14	904
ExxonMobil	$45	$166	39%	$130	782
Verizon	$58	$49	34%	$30	610
Coca-Cola	$64	$48	23%	$22	451
IBM	$49	$57	20%	$25	438
GE	$73	$84	9%	$34	405
Citigroup	$79	$132	19%	$46	347
AT&T	$123	$156	52%	$50	321
Chevron	$65	$139	34%	$42	299
Bank of America	$71	$146	21%	$43	296
Johnson & Johnson	$65	$82	12%	$22	269
AIG	$63	$56	6%	$11	191
Altria	$96	$160	19%	$30	188
JP Morgan Chase	$148	$203	25%	$35	172
Wachovia	$52	$67	12%	$10	156
Wal-Mart	$67	$63	5%	$9	151
Wells Fargo	$60	$150	17%	$18	118
Conoco Phillips	$70	$264	26%	$24	92
Intel	$34	$(32)	-17%	$(25)	N/A

Notes

1. Shareholder value created is derived by taking the average common shares outstanding during the period and multiplying that by the share price at the beginning of the period, further multiplied by the total shareholder return during the period.
2. The “real” dollar cost of the executive team is derived by taking the CEO, CFO, and the next three most highly paid executives who were employed at the end of the most recent fiscal year. Their “real” compensation cost is derived by taking their total compensation from the summary compensation table with the following adjustments: (i) stock options are included based on the increase/decrease in spread value year-over-year plus gains recognized at exercise; (ii) restricted stock is included based on the increase/decrease in value year-over-year plus the value of shares vested during the year; and (iii) performance shares are included if earned during the year.

compensation to be accurate and sensible.

Where we part company, however, is the use of annual total shareholder return as the ultimate measure of a management team's performance. Focusing solely on short-term stock performance, to me, is anachronistic and will only lead us to repeat the sins of the past. Over-emphasis on stock performance is what led us to multiple bubbles in the market and to excessive risk-taking by companies to boost their share prices, which puts the health of the corporation and job security for employees in jeopardy.

The movement of stock price, in both directions, is only partly determined by the performance of a company and the actions of its management team. A host of other factors, from the overall health (or malaise) of the market to industry trends to commodity price swings, have dramatic effects on stock performance, especially over periods as short as one year. For example, Zimmerman's ROX analysis pinpoints Exxon as a company with one of the highest "ROX scores" because its market value increased so much relative to how much executive pay increased. With oil prices at over $100 a barrel, one can argue that management had little to do with the company's huge increase in market value (which means they should have a high ROX score—even a medium-level ROX score would probably mean they had reaped too much benefit from a windfall they did not produce).

Paying-for-performance means rewarding management for those things over which it does have direct control; such as profitability, margins, return on capital, growth, and the overall well-being of the enterprise. Companies that keep putting good numbers on the boards in a consistent and reliable way deserve notice—and their management teams should be well compensated for their efforts.

My view of stock performance as an inferior arbiter of corporate performance was crystallized when I interviewed former Federal Reserve Chairman Paul Volcker for my book, *Stock Options & The New Rules of Corporate Accountability*. In our discussion, Mr. Volcker challenged the prevailing view about stock performance with his comments about the role of the stock market, which ultimately is to provide a source of capital. He further stated, "There are a lot more important things to the company than the day-to-day movement of the stock price."

In recent decades, Fortune 500 companies not only have stopped using the market for capital, but on a net basis they have bought back more shares than they have issued. So if corporations are not using the market to raise money, why are they so interested in stock price? (A good guess would be high levels of stock-based compensation.)

Using stock price as a proxy for how well the company is serving all its stakeholders—including shareholders, customers, employees, and the society in general—can be shortsighted. As Mr. Volcker explained, "The purpose of the company is really to provide goods and services at the best possible price, at the highest level of productivity, and in a way that serves society and communities. That is the purpose of the company. The stock is just the way that we get there."

That interview caused me to rethink the nature of what we are measuring and paying for with executive compensation. Clearly, it should not be share price appreciation (and dividends) alone. I favor a more balanced approach. This includes measuring those factors mentioned earlier: consistent cash flow, return on capital, margin improvement, and growth; however, these tangible components of corporate performance ultimately involve paying for the past. Equally important in today's competitive environment is for companies to pay for future growth by way of innovation, new product development, building a quality management team, implementing a great succession plan, and developing employees.

Admittedly these are less tangible aspects of performance, but we need to do a better job of quantifying and paying for them in order to build stable companies that create sustainable long-term value. Companies that can balance consistently strong and stable financial performance with innovation, succession planning, and employee development will produce long-term value for shareholders, employees, customers, and communities.

A European View

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"Executive pay is complex" begins Mr. Zimmerman in his article "Are You Getting A Bang Out of Your Executive Pay Buck?" Executive pay is also cultural and the information available, the way it is presented, and the ability for it to be understood are as much, if not more, a factor of geography, culture, and psychology as they are of accounting and mathematical formulas.

The establishment of a return on executives (ROX) score is an interesting approach, and, although the potential distortion of looking at a one-year time horizon is noted, it could have its merits once tested on a multiyear period. The article states the importance of making comparisons between companies of similar size and industry sector, but what about geography? Could the ROX score be applied globally?

From a European perspective, large, publicly quoted companies are operating more globally, are managed by ever-diversified executive teams, and have compensation committees whose members are from a variety of geographic and cultural backgrounds; therefore, the ability to evaluate and compare proxy information in a similar manner on a global basis will surely become increasingly important. Comparisons can be made to the increasing prevalence of relative as well as absolute performance measures such as total shareholder return (TSR) as criteria for performance-based long-term awards. Relative performance against a defined peer group can factor in size, industry sector, and geography.

Take a specific example. What if I, as an investor, an executive, or a member of a compensation committee, wanted to compare the "bang for the buck" of a large US-based financial services organization with that of a similarly sized Swiss-based financial services organization? Although there is clearly a global trend toward increasing transparency on executive pay disclosure, some jurisdictions are leading the way while others are very much in the stages of infancy. The difficulty is that legislation that determines the amount and type of disclosures required on executive pay is regulated at a national level and therefore is typically reflective of that country's cultural state of readiness to open up the Pandora's Box of compensation.

Across Europe, there is no commonality of approach despite the European Union (EU) Commission's having issued in 2004 a recommendation for "fostering an appropriate regime for the remuneration of directors of listed companies." Although the EU Commission closely monitors how its recommendations are being applied,

they are legally nonbinding for member states. In the United Kingdom, disclosure requirements on executive compensation are comprehensive and covered by a mix of statutory requirements, stock exchange regulations, and institutional investor guidelines. In Germany, listed companies were required as of 2006 to disclose the individual components of remuneration paid to the members of the executive board on an individual basis. An opt-out clause can apply, however, when at least a three-quarter majority of shareholders agrees to disclose only the remuneration to the executive board members on an aggregate basis, and the ability to apply the opt-out clause can continue for a maximum of five years.

In Switzerland, the increased public attention on executive compensation practices and levels has contributed towards a revision to the Swiss Code of Obligations through the implementation of the new Transparency Act as of January 1, 2007. This requires individual disclosures by name of the total compensation for each member of the board of directors as well as that accorded to the highest paid member of the executive board.

The biggest challenge facing both Swiss and German quoted companies is the move from aggregate to individual disclosures on executive pay. This is a huge cultural shift. Switzerland is renowned for its banking and financial services industries, and banking secrecy is a reality not a myth. In a culture of nontransparency it is not surprising that all of the research done on degree of readiness to comply with these new disclosure requirements would indicate that the majority of quoted companies in Switzerland are not.

It is, however, just a question of time. The intense focus that has come to bear on US companies, particularly from the press, is building in Switzerland. The key now is to take the opportunity to plan proactively rather than react defensively and get a company ready, before the inevitable opening of Pandora's Box.

This Approach Deserves More Research

Michael Schuster
Professor Emeritus
Syracuse University
and Professor of Management
United States Coast Guard Academy

Mr. Zimmerman is to be congratulated for his thought-provoking contribution to executive pay. He offers a novel way of evaluating the overall compensation of America's corporate leadership. As no one paper or theory is going to settle this complex issue, several aspects of his analysis—both good and bad—are worth considering.

Several salient points raised deserve to be underscored:

1. The focus on the executive team rather than just the CEO suggests a fruitful area of investigation. Although the press is subsumed with the sensationalism of some executive pay packages, thoughtful students of this subject may find consideration of the compensation of the leadership team an interesting area for consideration and research.
2. Executive team turnover deserves more attention than it is commonly given by the critics. Zimmerman rightly points out that the costs of severance for poor performance or inadequate cultural fit, as well as the cost of acquisition of talent, are significant. We would like to hear more of his thoughts in solving for that.
3. Director compensation should be tied to executive stability, according to Zimmerman. We agree; however, if there are long-term incentives to improve executive continuity, they must be paid out only when continuity equals business performance.
4. Zimmerman demonstrates the greater contribution of performance units/shares as providing enhanced incentive value in his sample. Performance units are shares of stock delivered to executives when corporate goals are achieved, such as earnings per share. Zimmerman contrasts this with stock options, wherein the executive has the right to purchase (exercise) the company's stock at the granted price by a defined expiration date. When stock prices increase in value, options add to executive wealth; declines make options worthless. Thus, performance shares are more valuable. More importantly, from my perspective, because performance units can be used when targets are achieved, they potentially can be deployed to enhance the effectiveness of a balanced scorecard by allowing metrics (e.g., diversity or sustainability) beyond earnings.

Look at annual performance a bit closer. I attempted to work with the ROX model using two of the top companies. A comparison of Exxon and Pfizer is shown in Exhibit 4 (including an additional year). For simplicity it excludes dividends (part of the ROX model) and shares outstanding, which would be used to calculate the change in market capitalization.

Although the return on shareholder value for each executive compensation dollar was higher at Pfizer than Exxon, as an Exxon shareholder I felt a lot better about my return than I suspect most Pfizer shareholders did. The next year's results (2007) speak for themselves; however, pure stock price (i.e., shareholder value) does not capture the details of how results were achieved or not achieved. In Pfizer's case, the removal of a high profile drug in development and a questionable pipeline suggest difficulties beyond the one-year timeframe that Zimmerman suggests as appropriate. At Exxon,

EXHIBIT 4

Year Over Year Change in Share Price: Pfizer vs. ExxonMobil

	Exxon	*% Change*	*Pfizer*	% Change
12/30/2005	56.17		23.32	
12/29/2006	76.63	36.43%	25.90	11.06%
12/31/2007	93.69	22.26%	22.73	-12.24%

directors will need to isolate the stewardship of the executive team in a volatile market from the increase in shareholder wealth derived from speculation, the terrorism premium, and a higher market multiple.

Zimmerman's model is useful, but represents only the first step in what would have to be an exhaustive study combining multiple years of data, a larger sample of companies, and sufficiently diverse economic conditions that better test its predictive value. Further, this approach would gain considerably more credibility if it was evaluated by university researchers, whose research design, statistical competencies, and absence of economic motive could be deployed.

Compensation: One of Many Critical Factors in Executive Effectiveness

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A goal of a corporate board is to pay executives as much as is necessary, but not more, to ensure that an executive team is in place that will deliver appropriate shareholder value. Mr. Zimmerman provides an important contribution to this overall discussion. Clearly, data is needed to measure the performance of the board in meeting this goal. Mr. Zimmerman's ROX Index serves to provide a helpful method of comparing a common data point for various corporations. In my view, boards should avoid a narrow focus on an economic metric when they assess the effectiveness of executive pay. Such a singular focus actually can be detrimental to maximizing the value of dollars spent in compensating executives.

Corporations can make more effective use of their executive dollars if they:

1. Ensure that the executive clearly understands the specific elements of the value of his or her compensation package;
2. Connect compensation directly to expected performance; and
3. Focus more effectively on the nonfinancial aspects of motivating and retaining key talent.

In my experience, top executives typically have surprisingly little understanding of the value of the various components of their compensation. Many executives have an overall sense as to the magnitude and the "fairness" of the compensation, but they do not have a detailed grasp of the various components, how they work, or how to maximize their value. When I first meet with an executive, it is common for him to admit to being embarrassed by a lack of understanding of various components of his compensation.

With the exception of some CEOs, executives rarely speak as though their future compensation depends on their personal effectiveness. They often speak in terms of doing better if their division has a good year or if the overall economy causes their stock price to increase.

If the executive does not understand her compensation and benefits, or critical components concerning them, and if she does not see a connection between her behavior and her incentive-based pay, how can such compensation and benefits possibly be effectively motivating or retaining the executive?

Compensation is just one of many factors determining whether an executive team will perform effectively. Nonfinancial factors motivating an executive team include:

1. Leadership that the executive respects;
2. Crystal clear corporate vision, mission, values, and key priorities;
3. Opportunities to shape the corporation's priorities;
4. Obvious and direct link of the executive's contributions to the corporation's ability to meet its vision and priorities;
5. Frequent feedback, in the form of public recognition and private correction—by financial and nonfinancial methods—regarding the executive's performance against the key priorities;
6. Support in tough times;
7. Positive overall work environment; and
8. Freedom to make prudent mistakes.

Financially, executives want to be compensated in a manner that allows them to achieve their personal financial objectives, and they want to feel that the corporation is treating them fairly.

Compensation is one of many critical factors, albeit the one most easily quantified. If corporations focus on the financial aspect of executive pay only, and not on other facets of what it takes to build and retain a talented team, then the financial cost becomes enormous. The cost to retain an executive who is working for a CEO she does not respect is expensive. Similarly, if the executive is working for a corporate enterprise to whose mission and values he does not subscribe, it will be costly to retain that executive.

One of the most respected business researchers of our day, Jim Collins, asserts that how you compensate executives has little to do with the success of the enterprise. Mr. Zimmerman supports this notion when he states: "a narrow focus on amount of pay alone can lead to questionable conclusions about the appropriateness of a company's executive pay program."

Companies need to work harder at connecting individual behavior and future pay effectively, and in communicating the intricacies of the various forms of compensation and benefits awarded the executive. In addition, the enterprise needs to create an atmosphere in which the noneconomic factors are closer to optimal. If closer attention is paid to these areas, it may be less expensive to motivate and retain key executive talent, and its overall ROX index score will improve.

Be the Sixth Highest Paid Executive!

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Although the ROX index provides companies with a useful tool to understand top executives' pay, it is only a tool . . . one of many that can be useful. The goal of any executive compensation tool, such as ROX, should be commended when it helps compare "apples to apples." Today, the summary compensation table, even with its faults, makes a credible effort to do just that. It might include accounting values, but the end result is more transparency than we have experienced in the recent past and is no more complex than an income statement or a balance sheet is.

As an EVP of HR at a Fortune 20 company and a board member of a publicly traded retail company (and member of the compensation committee), my biggest concern is putting the compensation practice in the proper context within the marketplace in which we compete for talent. The financial health of the company, the general health of the economy, the industry in which it competes, the impact of the true competitors upon the industry, and many more factors, affect the performance of the company and the fit for executive pay. Has the company been a strong or weak performer within its industry? Is it in a turnaround? Is the industry going through fundamental economic change? What is the track record of the top

management team? Was a substantial change in top leadership necessary? Is there a strong bench in place? Does the compensation decision-making process include an external compensation consultant, an outside legal counsel, and a competent internal executive compensation department? Does the company have a realistic, achievable strategy upon which to base its compensation practice? At the heart of the compensation practice, is the practice rewarding measurable, fact-based performance, performance that is crucial to the long-term financial health of the company?

The answers to these questions need to come together in a smart and candid story. That story should be told in the compensation discussion and analysis section of the proxy. If the story hangs together, is logical and authentic, constituents will be open-minded. What might make no sense for one company may make perfect sense for another. Some measures might be chosen in a particular year that seem odd, but are crucial to the long-term success of the company. That dilemma must be faced with courage. Sometimes, success cannot be driven in one year. Sometimes, decisions are made that will only show results in periods longer than a year. Look at pay levels in start-ups, for instance. They must be made to ensure the success of the company . . . long term. Our focus on quarterly or annual results sometimes negatively affects compensation decision-making.

Lastly, a company might quiet some critics by using a tool like ROX, but fail to answer "hot button" compensation issues like change-in-control pay. This is another important compensation lever not addressed by ROX. What if it is in the best interest of the company and its shareholders to sell it, either to another company or to private investors? How should pay influence shareholder interests in those complex decisions? The answer should seem obvious enough, but how should the top team's personal compensation (and futures) enter into their thinking? Should compensation committees take personal financial concerns out of the equation entirely? How many good deals are lost and how many bad ones get done because of individual incentives?

With regard to director pay, I believe directors are the true stewards of the corporation. Too much short-term pay-for-performance could also result in selling the long term for the short term. Although a ROX tool might alleviate some concerns, it cannot address all the important compensation questions we face today.

As a tool, ROX is one more useful model. But, do not look for these tools to tell the whole story. Context, characterizing the strategy over a longer period—and painting an accurate picture of an industry undergoing subtle or obvious change—can provide the insight in which important compensation decisions are made. In the end, the shareholders will decide if the story hangs together. If it doesn't, they will take their investment to a company whose story does.

The bottom line on all this? Be the sixth highest paid executive in the company and you will never have to explain your compensation to anyone, including your wife—or husband.

A Matter of Optics

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Who are they, those who question the pay-for-performance credentials of executive pay? Every spring, like daffodils popping through the warming ground, investigative articles appear challenging the validity of how the executive suite is rewarded. Critical commentaries by notable compensation experts, as well as a financial analyst here and there, will question whether job performance has warranted the amount of financial rewards reported in proxy statements.

What follows is usually a series of back-and-forth speeches and written pieces both criticizing and defending the logic of the executive reward process; however, those who press their divergent viewpoints seem unable to reach consensus on an equitable process, so next year the cycle of debate repeats itself. Such has been the case for years.

In my mind, the proverbial "man in the street" or "court of public opinion" is what truly matters. If you take the point that it is the general public who needs to be convinced that our corporate leadership is not unfairly gorging itself on financial largesse like hogs at a feed trough, then the article touting the advantages of a "return on executives" (ROX) falls disappointingly flat.

Unfortunately it is not the negative impressions of the general population that are being addressed by the ROX article, but instead a complex argument is presented supporting those who are being challenged, the executive leadership themselves. This is a circle-the-wagons article crafted to refute challenges to the current executive reward process by providing a technical defense that would not be understood by that same general population.

A CEO I admire and respect once told me, it's a matter of optics: The present system of determining executive suite reward *looks bad* to the general public. No amount of explanatory formulae or charts and graphs is going to change that impression; the more complex the defense, the more skepticism that will be generated.

Another senior executive cautioned that if I could not make my point on a single sheet of paper, including a lot of white space, then my arguments would not convince him. In other words, keep it simple, keep it clear, and keep it brief.

That has not happened here.

The ROX system is presented as a formulaic methodology that can be utilized through consultant intervention by corporate leadership to refute their critics; however, even as the ROX calculations try to make their point, the wider audience will remain unconvinced, so how has the argument been advanced? The reward system will still *look bad*.

Viewed in its entirety, the article presents an apologist viewpoint for current reward practices. Criticisms are only generally mentioned, without specificity, and the press and critics are considered biased and uninformed in their attempts to sensationalize individual extremes. Broad and unsupported statements ("most commentators" and "everyone understands") tend to offer up generalized assumptions cynically in support of a point of view. This is not dissimilar to an orator's working an audience to nod their heads repeatedly in advance of the controversial message point.

I like the idea of measuring performance to gauge the amount of reward. Who can argue with that? But the process being described here is flawed by its complexity, by its inability to explain itself in laymen's terms, and by an apparent sleight of hand (the author says the system works, but with "a couple of cautions") for the casual observer.

While holding up the ROX index as a useful tool to measure executive performance, there are several disturbing acknowledgements that would suggest the data "could" be skewed ("one year ROX scores can be distorted" and the data set "is too limited to support firm conclusions").

Even as an apologist for executive pay determinants, the author makes no mention of "how high is up" or how much is "enough" reward. Given that for similar performance nonexecutives receive considerably less, it is surprising that this disconnect was ignored. A large portion of the *looks bad* environment is the "amount" of the reward. Should those on "mahogany row" have parameters to their reward, like the rest of the population? This key issue is not addressed.

The problem connecting a pay-for-performance concept with examples of executive pay excesses is an optical one: It looks bad! Attempts to rationalize the practice with complex terms, charts, and theorem will not convince anyone outside of the board room. The way to change that negative impression is to challenge the convoluted methods that executives use to rationalize their reward structures. The general population (not the financial analysts, proxy readers, or specialists) wants to see a direct cause and effect (simple, clear, and brief), as that is how they are rewarded in their own lives.

Nice Idea, but Hard to Apply in Practice

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Wouldn't it be great if the assessment of the effectiveness of an executive compensation program could be reduced to a single measure providing the equivalent of a report card grade for each company's program? Executive compensation is at times overwhelmingly complex and any effort to simplify its evaluation is to be applauded. As we have seen from the enhanced compensation disclosures under the revised rules, more information does not always enhance understanding and can actually further confuse an already complicated issue.

In his article, "Are You Getting A Bang Out of Your Executive Pay Buck?," Ross Zimmerman proposes such a measure. He calls the measure the "return on executives," or ROX for short, and defines it as the total value made available to executives in a given period of time relative to the company's increase in total shareholder value.

Is ROX the hoped for measure that will simplify our understanding of the effectiveness of executive compensation programs? Unfortunately, it is not that simple. In theory, ROX is a potentially useful input in assessing the effectiveness of a company's compensation program, but there are a number of practical challenges to its implementation.

The underlying rationale for ROX as a measure is promising. All else being equal, a company that pays its executives $100 million over a period of time and increases shareholder value by $10 billion will likely feel it get a better bang for their buck than a company that pays its executives $100 million over the same period of time and only increases shareholder value by $1 billion; however, there are a few fundamental problems with the measure:

1. Company scale;
2. Timing of measurement; and
3. Differences in company circumstances.

Company Scale

As Ross Zimmerman mentions in his article, "ROX scores are generally positively correlated with company size." This poses a problem for using this measure as a basis to compare companies that are not very close to one another in terms of market capitalization at the beginning of the measurement period. The reason for this is that pay levels do not increase on a one-to-one basis with a company's market capitalization (i.e., executives at a $10 billion company are not necessarily paid twice as much as executives at a $5 billion company). Instead, pay levels tend to increase less than proportionately with a company's market cap. Unless pay levels increase proportionately with market cap, ROX scores will generally be better for companies with higher market capitalization. For example, if the management team of a $1 billion dollar market cap company was paid $10 million for doubling its market value to $2 billion, its ROX score would be 100 ($1 billion/$10 million), even though its shareholder return was 100 percent. By comparison, the management team of a $2 billion company that is paid $10 million for increasing its market value to $3 billion will also have an ROX score of 100, even though its shareholder return was 50 percent.

Timing of Measurement

Conventional wisdom is that executive compensation should focus on long-term performance, rather than short-term swings in company performance. As a result, for ROX to be a useful measure in evaluating compensation programs, it needs to be measured over the long-term. This adds complexity to calculating the ROX score and in using it for relative comparisons. Over a long period of time, many things can change that complicate relative comparisons (e.g., changes in management teams, different industry economic cycles, and different timing of long-term incentive grants/option exercises). Depending on the arbitrary start date and end date of the ROX measurement period, very different results for the ROX score will likely be obtained. To be sure that a program was working well on the basis of ROX, the ROX score would have to be analyzed over multiple time periods for nearly identical companies. This sensitivity to timing limits its practical utility as a measure.

Differences in Company Circumstances

Another challenge in using ROX is that different companies face different circumstances. Consider two hypothetical companies as an example. Company A is in a declining industry in which relatively flat shareholder returns represent remarkable management performance. Company A has not created any shareholder value over the last five years, but its industry peers have lost half of their market value over the same five years. Company B is in a booming industry. Its annual shareholder return has been 15 percent per year over the last five years, above the broader market average of 10 percent per year for that same period of time. Company B's most direct industry competitors have provided a 30 percent shareholder return over the last five years. Relative to its industry, Company A's performance is better than that of Company B relative to its own industry; however, Company B's ROX score will be higher than that of Company A.

Conclusion

ROX is a nice idea in theory that is hard to apply in practice. Unless two companies are nearly identical in terms of the following company factors: market capitalization, industry, growth prospects, and management tenure; it is difficult to use the measure as the basis for relative comparisons. Use of ROX as the basis for assessment where firms are not identical in terms of the preceding factors may lead to false conclusions that are not justified once company specifics are taken into consideration.

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How Coke's CEO Aligned Strategy and People to Re-Charge Growth: An Interview with Neville Isdell

Gregory Kesler, CHRS, LLC

When Neville Isdell was summoned from retirement to become chairman and CEO of The Coca-Cola Company, he faced a lot of bad news: health-conscious consumers who were saying "no" to carbonated soft drinks, stagnant new product creation, years of cuts in direct marketing, a stock price that had been pummeled for more than four years, and a business press that had pronounced "the fizz was gone" from the Coke formula. *The Wall Street Journal* wrote that investors were skeptical that Mr. Isdell could return the company to consistent growth. Coke's bottling partners, with hundreds of thousands of employees all over the world, were equally disappointed in the direction of the company and many were not ready to invest in untested new product and package ideas.

Although the brand still held enormous value and cash flow was good, Mr. Isdell's daunting task was to turn around an icon in trouble—to return The Coca-Cola Company to growth.

Mr. Isdell's leadership, along with that of Muhtar Kent, the successor he helped identify and develop, has enabled the business to meet its growth targets 11 quarters in a row. The company delivered a 30 percent total return to shareholders in 2007. That same year Isdell pulled off the $4.1 billion acquisition of glacéau, makers of vitamin water. CNBC recently described him as a transformational CEO. Late in 2007 the company announced Isdell's succession plan, which will take place in July 2008.

Born in Ireland, Mr. Isdell moved to Africa at a young age and began his career with The Coca-Cola system in 1966 with the local bottling company in Zambia. He later delivered stellar results for the company in several international posts including the Philippines and Greater Europe. In 1998 Mr. Isdell left the company as president of the Greater Europe group to run a major bottler, leading the business through a series of divestitures and mergers. He retired from a successful tenure as CEO at Coca-Cola Hellenic Bottling Company in 2001. Two years later he was happily splitting his time between the south of France and sunny Barbados when the board asked him to come back as Coke's chairman and chief executive.

People & Strategy's special issue editor had the opportunity to interview Neville to understand more about the thought process and leadership behavior of a successful chief executive in a large multinational company paying a heavy price for its change-resistant culture. What emerges is a look into the role of a chief executive who is rebuilding excitement and belief in a brand, while driving change in culture, strategy, structure, and executive talent.

GK: When you arrived at the company in Spring 2004, what did you discover?

ENI: One of the striking things was the exit of high caliber people because of disenfranchisement over recent years, including two poorly implemented reorganizations and lay-offs. But many people were waiting for change, believers with a special relationship with the company and the business, and we knew we could tap into that group to drive a turnaround. That was a critical belief—because at the end of the day we're a management and creative services company. We provide franchise leadership and marketing ideas that drive our larger Coca-Cola system. The people equation is critical.

GK: Where did you start?

ENI: We had not been making our goals for a number of years. We had to deliver, but I needed to invest as well; I needed to regain the commitment of our people. I made it clear that I was here to take long-term action, and that I wanted to go out and listen and communicate before making a lot of changes. I didn't want to talk to investors or the press until I had completed that listening process.

GK: You engaged people in creating a new growth strategy. Tell us how you went about doing that.

ENI: I dug into the employee engagement data and created some hypotheses and then tested them. It was all about recharging morale. The data said our people had no belief in management or in our ability to grow our core versus buying other businesses; some believed we needed to buy a management team that could run the business better. In August 2004, we had a kick-off with the top team in London to begin building what we began to call our "manifesto for growth." The senior leaders were confused at first about what I was doing. We had to confront our own lack of confidence—confidence that we could grow our core business, for example. It was a loosely affiliated team with distant relationships, but when they understood what we were trying to do they became very involved. They became a team. We asked them to dream a little. Then we asked, are we ready to do the work? After some real catharsis we tapped into the passion and the caring. This initial work was basically repeated in a collaborative process over the next eight months involving the top 150 leaders around the world, engaging them in the creation of our future architecture and strategy.

EXHIBIT 1

Isdell's Manifesto for Change

1. Listen and find a core group of leaders who want to be part of the change—make them owners.
2. Build coalitions inside and out—then have the courage to move ahead.
3. Be direct with people; draw tough lines on performance.
4. Use the executive talent process and organization structure to drive change and develop new leaders.
5. Model all the leadership behaviors you expect from others—stay away from arrogance.

GK: It took some time. How did you manage the many crises the company faced?

ENI: We started slow, but it was a matter of going slow to go fast later and the evidence is in the results. There were quick hits we started immediately—we weren't waiting to fix things—like reinvesting $400 mm in marketing, and refocusing our R&D spending—coordinating new product-development investments and consolidating some corporate staff groups to gain some leverage. That helped to build confidence.

GK: What role did you personally play in the "manifesto process?"

ENI: I stayed very involved in the process without sitting on the various design teams doing the work. I believe in people and trust them, and only occasionally have I been let down. In this way you demand amazing things and you get them. We changed everything —moving away from the "think local-act local" organization to a middle ground that did take some decision rights away from the regions.

GK: What did you discover with regard to executive talent in the business?

ENI: Initially, I took the president role on myself, in addition to the roles of CEO and chairman. I had a clear view of what needed to be done. I didn't want to confuse that by bringing in an outsider who would be on a learning curve.

The manifesto process was revealing. Three obvious talent gaps were at the executive level:

1. We needed someone new to lead HR, because there was low regard for the function. I had a solution for that with Cynthia (McCague), whom I had worked with in CCHBC (a large bottler based in Europe).
2. We needed a different marketing leader. Within the first three weeks I elevated a seasoned marketing executive, who could help stabilize the business in the short term.
3. We needed a voice for our bottling network at the table. We previously ignored that connection and failed to recognize this key capability as necessary within the company. To rectify that, we brought in a strong bottling executive from our system to lead the company-owned bottling operations.

GK: You have spent a lot of time on organization design and executive talent. Tell us how you worked those two levers together to drive change?

ENI: Once we convinced our leaders we were here to grow the business—after about a year—I could make more aggressive changes, like setting up the integrated marketing, strategy, and innovation organization under Mary (Minnick) to break down the silos among those pieces. We brought in Dominique Reiniche, a bottling operations executive, to run Europe, and made Muhtar Kent our head of international, and later elevated him to COO. Initially, there was no grand design, but the organizational structure began to evolve quickly. We reconsidered the role of the corporate center functions as well as the role of our (geographic) division presidents. We challenged the sanctity of our division structure. "Freedom in a framework" was an idea we asked leaders to embrace. We changed the structure, but it's not about central versus de-central. We want leaders making decisions and we want those decisions to fit inside our manifesto for growth. Eventually we narrowed the membership in the executive leadership team in order to move more quickly.

The manifesto set the stage for a new look at leadership talent. Early in the manifesto work, we identified critical capabilities necessary to deliver sustainable growth. These provided direction for the HR function, as well as the operators, to work on assessing and developing our people and on building new processes. We identified four key capabilities to drive growth: brand marketing, franchise leadership, innovation, and people development. We are expanding the product portfolio to meet consumer needs around the world, and it means building or acquiring many new skills.

We haven't done enough, but as a leadership team we've invested a lot more management time in people development over the past three years—again, tied to the realization we are fundamentally a creative-service business. Most recently, we've set up a women's leadership council to accelerate the global recruitment, development, and advancement of women at the company, and Muhtar is leading that now.

GK: Is there a global executive profile for Coke, in your judgment?

ENI: We operate all over the world, and we need more leaders with international experience. These jobs in emerging markets grow resourceful, broad-minded leaders. We made it a point to ask managers to take more lateral assignments, and we want them to move across markets, and sometimes functions. We've spent more time talking about execution: We need well-rounded leaders who can execute. We're leveraging the people-development programs that were invented in Europe or Asia or Latin America, all around the world, rather than inventing everything here in Atlanta. They're still global programs but various geographies act as stewards for these practices.

GK: You've done a lot of assessment and coaching of leaders these past few years. What role has that played in the change process?

ENI: Honesty and feedback were part of the values we espoused in the manifesto. We joked that the company had become a "feedback-free zone," and we knew that had to change. We started with performance evaluations of people in year one, which hadn't been done. I prepared a narrative evaluation of each executive committee member following a deep discussion with each of them. My coaching was behavioral. I want leadership role models. I looked for ways to model what I wanted from my executive team. Those evaluations were hands on, while I was traveling all over the world. I never worked harder than in those first 18 months.

We're leveraging the people-development programs that were invented in Europe or Asia or Latin America, all around the world, rather than inventing everything here in Atlanta.

As you know, each leadership committee member went through an intense assessment and feedback process—as did I, followed by most of our division presidents. We rebuilt our executive-talent reviews to make them more interactive and more results-oriented. Muhtar challenged everyone to make sure these discussions led to action. We changed the culture as a leadership team by working together to evaluate key leaders—more candidly, more openly. As an executive committee we worked on staffing scenarios that

led to executive changes in Japan, China, the Philippines, and other key markets. We made moves to broaden the experiences of our future top executives. Cynthia worked with several of our division presidents to establish a general management assessment program for growing more international GM talent. The manifesto for growth was the basis of that work. The job isn't done by any means.

GK: The team made some tough calls in some of those assessments.

We rebuilt our executive-talent reviews to make them more interactive and more results-oriented. . . . We changed the culture as a leadership team by working together to evaluate key leaders—more candidly, more openly.

ENI: We worked hard to build morale, but we also made tough people decisions. We didn't make exceptions to our standard separation packages, because by then people knew where they stood. We drew a tough line and we didn't make deals.

GK: What's next?

ENI: We are only half way to where we need to be in growing the leadership pool. We want leaders throughout the company to show what Cynthia calls "an eye for talent." We have to continue to build the product portfolio with our bottling partners, while continuing to grow our core business—and we're facing many new competitors. This means we've had to grow many new skill sets.

GK: You went outside for some key players. What role did culture-fit play in those selections?

ENI: We talked in the manifesto about the need to take more of an external view of the world. We tried to pay attention to cultural fit for the most part, but in some hires we intentionally set up some tension to force change. I told Cynthia when we hired one senior executive that he was going to make us very uncomfortable and that was just what we needed in that role. We did a couple of those but you have to choose where you put them and not overdo it. I spent a lot of time in those selections making sure we were aligned, and in helping to sell the company to top candidates, which was necessary early on.

GK: How did you involve the board in those moves?

ENI: I was open with the board about the gaps. We told them we wanted three ready-now players for every key position. We're not there, but we've moved from 0.8 to 1.6 on average. The board and I worked together on the successor issue from the beginning of the process.

GK: You will be passing the CEO role to Muhtar Kent soon. Can you share a little about how the succession process played out?

ENI: Muhtar's business know-how was always apparent and we invested a lot in his broader development, involving the board from the beginning. We managed the first phase of the company's return to sustainable growth as a relay race, and we are managing the succession process that way. The reality is that we are managing a transition here, including my staying on as chairman through April 2009. Muhtar and I can do this because we have a strategy we have created together and because we trust each other. There will be stylistic differences between us, but the future path is clear and we are on the same page. We are taking on difficult questions right now and we're doing it together. We've just completed a refreshing of the manifesto, and Muhtar has led that work.

GK: How has the role of the CEO changed in your judgment? Any counsel for your business colleagues?

ENI: We have tried to eschew executive ego, as a culture and as individual leaders these past four years. The energy and drive that come with these strong personalities make that difficult sometimes. We have not lapsed into arrogance. In some ways I've done the easy part. Muhtar takes over a healthy business with growth and belief in itself, but he will have to take it to the next level.

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Changing Your Company's Strategy?

Better Change Its Personality, Too: The CEO-HR Executive Partnership

Dan Ciampa, Author and Consultant; George Stalk, The Boston Consulting Group, Inc., and Rotman School of Management, University of Toronto

The notion that culture trumps strategy has been around a long time—probably about as long as the idea that "people are our most valued asset." Unfortunately, this view of culture is given about as much attention as the valuing of people at most companies. Dan Ciampa and George Stalk, two long-time, clear-eyed strategy consultants, argue strongly that CEOs who neglect culture while trying to change strategy are doomed.

At the same time, an organization's culture typically is well established and difficult to change. Most CEOs are much better at strategy than culture. They lack much of the basic knowledge and skills required to change cultures to support new strategies—often doing too little or taking on too much. Instead, success comes from targeting the few new and critical behaviors people in the organization need to learn to support the new strategy. The role of the CEO and his or her key internal advisor, hopefully the HR head, is to lead the efforts to change behaviors, paving the way for the new strategy to take hold.

This article shares a case study that is a composite of several situations we are dealing with today, then draws out relevant lessons that support our beliefs.

New Leader, New Strategy: Lessons from a CEO-CHRO Partnership

Brian's retirement party was a rip-roaring event. Toasts all around and for good reason. The company had just become market share leader in its industry and completed a third consecutive year of record earnings. Bonuses were at an all-time high. A lot could be and was said of Brian's accomplishments as CEO in the previous five years. Then, Wendell, the lead director, got up to speak.

"Brian, you and I have always liked each other but I have to say that a year after the board made you CEO we were all beginning to worry" said Wendell. "You were picked because the company needed someone who could deliver year-over-year earnings growth. Instead, you wanted to turn this place upside down. The board began to think we made a mistake. We even discussed firing you."

Wendell continued, "we would not be having such a good time tonight if we had. You not only convinced us the company needed a dramatic new strategy but you actually pulled it off! But what was brilliant was the way you changed the company so it could actually execute the strategy. We weren't sure at all that could be done, but you did it. Thank you from all of us." With that, Wendell sat down.

The Background

Brian knew he had been on shaky ground early in his tenure as CEO. He also knew some people did not understand why he spent so much time in the field and with customers. Brian had come up through the finance function but now he wanted to talk with everyone, and "walk the line" through all of the company's plants, customer operations, sometimes even into the customers of customers. How do things work? Why this way? What happens when someone demands a change? At first his direct reports went with him, most to ensure their area looked good to the new CEO. Eventually they gave up traveling with the "Brian show," leaving Brian in the hands of people two or three levels down in the organization.

Brian learned a lot when he was with people two or three levels down, like their dedication to serving customers and angst when they could not do it as well as they wanted to do. Brian also learned a lot from customers. He found too many who were much more satisfied with suppliers from entirely different industries than Brian's, but not enthusiastic about Brian's company or its competitors.

When Brian reached the periphery of his company's reach he found people who knew how to get things done, often without help or approval from the chain of command. He found some geographies with dramatically better market share positions, and some in which local managers were able to obtain price premiums unheard of in larger markets.

What Brian learned caused him to question the strategy of the company. Its last strategic innovation was being the low-cost producer. It closed and consolidated small plants, automated processes, delayered, and outsourced. Brian himself installed an ABC accounting system that showed every customer's profitability by product and service level. Productivity was at an all-time high.

As he learned more, his beliefs changed about the business and what was most important for sustained success. His feelings changed about those things he had long considered important. His own sense of confidence to direct the company changed.

Trouble loomed as Brian entered his second year as CEO. The company had to restate the operating plan because of delays in new product introduction. A general economic slowdown and over capacity in the industry increased anxieties further.

At the April board meeting, Brian painted a bleak picture of the industry's momentum, concluding that it had limited ability to grow for a period lasting much longer than the best predictions of the duration of the economic downturn. He said the largest competitors had enough capital to weather this period and could easily cut costs and slow development without major short-term consequences, but the next-tier companies like theirs would suffer more and, if the downturn lasted longer than some predicted, would be so weakened that they would be likely takeover targets by larger companies.

Brian believed this scenario was so probable that the company had only two choices:

1. Become a more attractive takeover candidate by pushing up short-term returns and putting off investing in the future to gain as high a price as possible; or
2. Decide to remain independent and go on the offensive. Using terms surprising the directors who knew him well, Brian said this second path required "bold strategies," "aggressive actions," "breaking old habits," and "changing how we do business."

   When Wendell asked Brian whether the company could succeed on this second path, Brian replied: A strategic change like this has to be a decision of the board, not mine. But I have two things to say. First, the easy road would be to just get ready to be acquired. We could do a good job of that. But, having to do the things to make that happen would rip the soul out of this company. We didn't work hard all these years to see this company become a division. The other thing to say is that it will not be easy because change never is. But, we can do it . . . I've never been more convinced of anything since I've been in this company.

The New Strategy

At one level, the bold new strategy was straightforward. The company, Brian believed, had to let loose its fixation to be low cost and instead become the service leader in the industry. He summarized the opportunity this way: Customers wanted the best price but they were paying premiums to suppliers from other industries for better service. The company's smaller geographies were getting great returns by offering great service: In effect, they had already made the shift to a service leadership strategy.

> Service leadership means being the best and fastest in four areas. First, at how new products and services are designed, introduced, and get to market. Second, at getting our sales and operations planning systems to anticipate what customers need as much as they tell us what happens after the fact. Third, linking our plants and distribution system to work off the same information, all aimed at getting the right product

to the right place at the right time. Fourth, at managing our supplier networks so quality problems are fixed before items get to our receiving docks. If we can excel at those four things, we'll end up on top of this market . . . and if I'm right about how the industry will do over the next few years, we'll be in a position to be the hunter, not the prey.

Although straightforward at one level, at another the strategy was difficult. As Brian observed:

> To do this well we have to redefine what we mean by being process oriented. Now, because of the way we're organized and interact, we deal with each process separately. I've always considered us efficient, but when I started to look in this way at how we operate, I realized we aren't efficient at all. We waste a lot of time and money fighting ourselves and our customers.

A director asked Brian what it would take for his managers to make the fundamental shifts necessary. Brian replied:

> We need the mindset that whatever we do can always be improved and something that's just okay isn't good enough. They have to be dissatisfied with the way we operate today, but they have to all be going in the same direction toward something else too, and be willing to change how they've acted for years. I'm not sure how to do all that. I'd like to come up with a plan to deal with these people issues, just as we did with our financial plan and the product plan. It took me a while to make up my mind about this, but we have no time to let everyone else [on the senior group] take as long.

A new strategy requires people, including the CEO, to behave differently than they have in achieving the old strategy, but most pursue new strategies without pausing to identify new behavior required.

Now the Hard Part

On the flight home, Brian could not get out of his mind the nagging question: So how do I change what has to be changed? He decided that the easiest, and hardest, way was to replace some people. On a legal pad he drew three columns. In the first, he listed the people who seemed to fit the new strategy, who when they had a problem with a proposed change did not put up obstacles but tried to find options. In the third column he listed people who probably did not have a chance of fitting, who always pointed out why something new would not work, whose best offer was barely incremental, or had ideas but never seemed to follow through. The middle column was for those he was unsure of: dependable performers but not creative or people who seemed to be willing to change but had not been in their jobs long enough to implement much. As his flight was landing, he realized that the names in the third column were among his most senior managers.

In the following months, Brian began to reshape the company. First, he convinced the long-time head of operations to take an early retirement package and, passing over two vice presidents who expected the job, replaced him with a young executive from the smaller but profitable international division with experience in marketing, product development, and operations. Within a few months the two vice presidents left the company without Brian's trying to keep them.

Managing the Board

He knew the directors would take notice of the departure of three top people and called the most important ones to explain his decision. He said that the more time he had spent in foreign markets and, in particular, with customers, he became convinced that division operated better because:

> Things just got done faster over there. This young guy figured out what customers wanted most had to do with speed. But everyone, us included, kept concentrating on price and new features instead of shorter lead times, quicker delivery, and better service.
>
> So he convinced our guys to take time out of everywhere they could. We used to think they could control their costs well because they were smaller and less complex [than the domestic operation]. But, by doing everything faster they reduced operating expenses but grew revenues, too, because customers loved the faster service. We have to do the same thing in the whole company.
>
> But the thing is that our guys here don't get it. We need someone running operations who knows our company but understands that doing everything faster means a different way of operating everywhere, a different way of thinking about the business. I knew it was going to upset some people but the benefits are too great for us to wait.

One of the directors asked what he meant by "a different way of thinking about the business." Brian replied that he had come to believe that for the company to thrive there had to be a fundamental shift in how his managers thought about their roles, accountabilities, and priorities. How to do that had not, however, been thought through. "The new strategy says why to change and what has to be done, not how we should operate. Our behavior is geared for the strategy we've had, not the one we need."

"You're talking about the whole damn culture changing, Brian," Wendell challenged. "That's a big thing to take on." Brian replied, "I'm not sure how far we have to go. I don't want to mess up the good things. But if we don't change some things, we'll be in real trouble."

Brian then dropped another bomb. "I've decided to replace [the head of human resources]. He just isn't broad enough to pull this off. I need a partner who gets it. Who comes to me with ways to get

people to act differently . . . to educate me, not someone I have to educate. I know I can't delegate this, but I can't do it all myself either."

The directors were polite but said nothing to convince Brian that they agreed with his decisions. Brian felt the ground tremble.

A New Chief HR Officer

Carol became the SVP of human resources a few months later. She came from a corporation known for mastering continuous improvement and time-based competition techniques. She won the job because she was the only candidate with a clear answer to Brian's nagging question of how to change what had to be changed. When she said a lot of companies err by trying to change their cultures, Brian, thinking of Wendell's challenge about culture change, began to relax. "Cultures in organizations like in societies are complex . . . even if you could get yours to change, it won't happen fast enough for what you have to do. The question is how to get enough people behaving differently quickly enough to make a difference." She said because she did not know the culture of Brian's company, she could not say what had to change, but she believed in a handful of principles that could guide a leader in answering that question:

1. Thinking differently involves attitudes. But attitudes change gradually and usually because of small experiments with new behavior. Companies waste time trying to change attitudes to get new behavior . . . it should be the other way around. People try new behavior in experiments to take out time or cost . . . when they see it work and get rewarded, they start asking questions about what they've always done. That's when their attitudes start to change.
2. Change on a large scale requires people at the top of the company to work on themselves first before asking others to change their behavior. Each layer starting with the CEO down to the lowest tier in the organization must learn new knowledge, skills, and behaviors. As subordinates see their bosses struggle with the challenges of change, willingness increases to experiment and question old habits.
3. Behavior changes when people have a new mental image of a much better way of working, of an organization that, compared to what they experience today, is so attractive that they will try to reach for it. Instead of asking what has to happen next, jump ahead to where you want to end up. I think you're close to having your own mental picture of the way things should be from listening to customers and your own people. Maybe what needs to happen now is to push it to be even more specific.

   She explained that others will be more ready to change once Brian describes clearly what he would see and hear when concern for the customer occupies the central role in what happens and when everyone is dedicated to speed as the way to get things done. "You have to go to the next level beyond listing objectives and describe what you'll see and hear that you don't today."
4. This kind of change is not "what most people call the 'soft stuff.' It is hard nosed with specific strategic and operational objectives, not just better teamwork or more satisfied employees." She said that relationships should be improved only after it is clear that they will lead to faster execution, more innovation, and better efficiency. Every change effort will require that some people leave or get repositioned because they just do not get it or will not change. Brian liked what he heard.

When Strategy Changes…

- Attitudes must change . . . but first, behavior must change.
- Top executives must work on themselves before asking others to adopt new approaches.
- Motivation to change depends on a clear, compelling mental image of a better state.
- Hardball actions are necessary, including replacing people who will not adapt, plus cultural improvements identified and measured for operational gains.

As he heard this, Brian felt his confidence rise. He believed Carol would give him honest feedback, challenge him, and become his primary internal advisor in leading the company to achieve the strategy. Brian had not used many external advisors in his career. He found academics too impractical and consultants better at selling an idea than making it work. But he had several informal advisors. Wendell was as much a strategic advisor as he was a director. The person Brian had succeeded as CEO advised him on operational matters. Brian's wife, who knew better than anyone else his hopes and vulnerabilities, was his primary personal advisor. But when it came to getting people in the company to change, more of a political challenge that Brian felt was testing him profoundly as a leader, he had no one to whom he could turn. That gap in his advice network did not become clear to him until he interviewed Carol. He had found his political advisor.

Brian had sought advice from other CEOs experienced in service leadership. They all emphasized a commitment to continuous improvement. Because of Carol's experience with these approaches, Brian asked her what it takes for them to succeed. Carol summarized:

> These techniques are a perfect complement to a customer-focused service strategy, but they won't work unless people act differently. [One study says] only 30 percent get [hoped for] results and [sometimes] things are worse after it's all said and done. What happened in [her previous company] was pretty impressive but we had a different starting point. The question we have to answer is what's going to work here.

Brian replied, "No, that's the question *you* have to answer."

A few weeks later Carol attended her first senior management team (SMT) meeting. After describing the conversations he had had with Carol about the connection of continuous improvement, culture, and the new strategy, Brian said Carol would come to the next meeting with some ideas on how to proceed.

Over the next month, Carol met with each SMT member, traveled to the field, visited customers, and learned as much as possible about her new company. At the next meeting, hers was the first agenda item. Rather than laying out any specific program, she began with her understanding of the former strategy and the new one, why the change was important, and, from what she had learned so far, the organization and people-related factors that were most likely going to block progress.

As Carol spoke, Brian noticed the others paying close attention and deeply engaged. The dialogue on what was required to deal with these cultural factors was lively and went well past the allotted time. He realized that in just six weeks Carol had grasped the essence of their situation and was describing it more clearly than any of the others could. They were learning together how the strategy

and culture interacted.

As the discussion was ending, one of the managers asked, "what's it going to take to do all this, Carol?" She said:

> If we decide to go this route, I'll come up with a detailed plan. Generally, first, go a step at a time in the beginning, avoiding a big elaborate program. Second, get early involvement from influential people whom others look up to. Then, get pilots going on problems that our people are frustrated by and really want to solve . . . and get results that are really impressive. When it's time to educate people, make sure the programs are tailored to us, not some general one-size-fits-all stuff. Maybe the most important is to make it okay to make mistakes as long as we can learn from them . . . and to have a real lessons-learned process for what we do well and what doesn't work.

She concluded, "the thing that will make all of that happen, or not, will be what we in this room do. People will get serious about this if they believe we're serious. That means us being clear about the kind of place we want and then acting like we are telling them to act."

Brian in just a few years didn't change the organizational culture but did change a lot of behavior. In response to customer and employee comments, people were given more freedom to decide how to compete.

The Results

Over the next two years, the new strategy succeeded both financially and culturally.

Inventory was reduced by 60 percent, quality improved by a factor of two, and working capital turns tripled. Speed improved everywhere. When the time-based approaches that had been honed in operations were used in product development, time to market was cut in half. When applied in marketing, the pricing process became more flexible and responsive. Even corporate functions benefited with Carol's using HR as a beta site to cut response time on everything from responding to employees' questions on benefits to replacing someone who had left the company. Finance reduced the time it took to close the financials and engineering halved the response time for a product design change order.

There were also changes on the organizational front. By the time Brian retired, only one remained of his nine direct reports who had been on the SMT when he had become CEO. Because of the efficiencies, he eliminated departments and combined functions, producing a more streamlined, flatter structure. Also, he created a senior manager group (SMG) made up of 100 upper-level managers. Membership depended on performance so if achievement of individual and unit objectives slipped for more than one cycle, that manager would be replaced on the SMG. Brian led the group personally, giving him the chance for direct contact with the next generation of managers and providing a forum to discuss how to best become the service leader.

The group sponsored customer surveys and shared results throughout the company. A small number of managers were "lent" to key customers or suppliers where, by being on site, they avoided problems that otherwise would have taken time in their company; they also came to better understand how their company was seen. When they returned, they spoke of their experiences at SMG meetings. From those discussions, a lessons-learned process evolved that grew to the point that it became commonplace throughout the company to capture insights after successes as well as mistakes. The SMG also sponsored a first-ever employee survey to gauge overall satisfaction with how the company operated and asked employees to point out barriers to speed and product quality. Just before Brian retired, the group's focus shifted to working capital productivity as a measure of the total improvement resulting from the various initiatives. The results changed the way improvements were designed as well as measured.

The degree of openness in the company also changed. The new strategy depended on an open, rapid sharing of information, but transparency had never been encouraged. As a result, a division would know only how it and the whole company had performed. Also, staff functions' performance had never been measured. At Carol's urging, that changed. It was agreed that annual operating plans of divisions would be shared and, in a year-end meeting, performance versus target would be revealed. For the first time, corporate functions went through a disciplined strategy process including posting progress on goals for cost control and responsiveness to the division's needs. With this degree of openness, Carol and Brian understood that unless there was a spirit of cooperation, the results could be divisive rather than positive. Brian committed to improving the ability of management groups to work as effective teams, starting with the SMT and including 360° reviews. To emphasize the need for openness, Brian published on the company's intranet system the results of his own 360° review.

Carol became executive vice president in charge of human resources, company strategy, new product development, and information technology. This promotion recognized her ability to think and act strategically as well as her contributions in driving needed changes.

In spite of the industry slowdown and pricing pressure, the company was stronger both financially and culturally than ever before. That enabled three acquisitions in the final two years of Brian's tenure. Some people credited the continuous improvement program, whereas others pointed to opportunities missed by competitors. Most agreed that it was a combination.

George and Dan discuss some lessons.

What can be learned from this case study about the degree to which a culture of an organization can change? What does it say about the challenges a CEO faces in leading the organization through such a period of change? What should the CEO expect about the contribution of the HR chief? We met for several hours

one day after writing up this case study to discuss these questions.

What lessons can be learned from the people we have called Brian and Carol in this case?

DC: Brian, first of all, believed there had to be a way to get people to change. He was under a lot of pressure from his board to get something done and they weren't exactly thrilled about the road he wanted to go down. He could have been conservative and moved on costs to boost productivity. Instead, he laid the groundwork for what ended up being a bigger success story than anyone predicted when he became CEO.

GS: Another lesson is that strategy and culture go hand-in-hand: You can't have one without the other. In particular, the CEO can't separate his role in directing both. Brian led this change effort himself and did it in a strong, unambiguous way. He didn't delegate the responsibility for either the strategy or the culture, but saw them as two sides of the same coin that he had to control.

DC: Then there is Carol. A big part of why she contributed what she did was the way Brian managed her. He saw something in her during one of the interviews that told him she was the one he needed. Beyond how Brian handled it, Carol was the costar in this scenario. She is broader than most HR people and more strategic. She didn't hesitate to take the initiative in contrast to many HR people who would hold back, not knowing how to lay out a plan to change behavior and make it convincing to senior managers.

Should the target be culture or "organizational personality"?

DC: I agree with what Carol said in the case. Organization cultures are formed through evolutionary processes over long periods of time and it is difficult to change them. Rather than a whole different culture, a strategy requires changes in how people respond to what happens internally and externally. George, this is something you've called changing its "personality."

GS: If someone had asked me 10 years ago whether a strategy or culture comes first, I would have responded with "strategy." Today, I believe differently. Strategy for many companies is about what their people do and the choices they make rather than about technology and marketing spend.

All companies have personalities that define their strategies and vice versa. Wal-Mart's personality is different from Nordstrom's, Starbucks' from Dunkin' Donuts'. Brian's company had a low cost producer personality, but now has a strategy that demands a different way of acting, one that lives in the customers' life in a way that provides better service. It all came down to which personality was best for the new strategy.

Four Ways Behavior Shapes Personality

- Freedom: To decide how something should be done
- Decision making: Tradeoffs between analysis, speed, involvement
- Openness: Results and reasons for decisions transparent or known by only a few
- Purpose: Overarching mission that motivates and inspires

How can someone in Brian's position change his company's personality?

DC: How people act in several categories shapes the organization's personality. One is *freedom*. Some organizations set rules from above; others expect initiative to decide how something should be done. Another category is *decision making*. Some companies require careful analysis, as making decisions quickly is sacrificed for the absolute best one . . . other organizations emphasize as much involvement as possible. Third is *openness*: for example, whether results and reasons for decisions are openly discussed or closely held. Fourth is *purpose* . . . in this sense, the overarching mission people should strive to fulfill that will be motivating enough to do what they have not done before.

GS: So, how freedom, decision making, openness, and purpose is managed shapes organizational personality, and the CEO has to make sure they are consistent with the new strategy.

DC: Brian in just a few years didn't change the organizational culture but did change a lot of behavior. In response to customer and employee comments, people were given more freedom to decide how to compete. By emphasizing speed, managers had to make decisions faster. Through the SMG, involvement ensured buy-in and, ultimately, better results. Staying independent versus being acquired provided a new compelling purpose.

GS: Also, they increased openness by sharing performance data across the company and by Brian's publishing the results of his 360 on the company's web system.

Those are broad themes . . . what do you do on Monday morning to get the personality of a company to change?

DC: Carol's principles are a good place to start. One was that the senior team has to agree on a new mental image that depicts clearly how people must act to realize the new strategy. In their case, it was not left to generalities—they forced themselves to be specific.

GS: Using specific metrics, customer service improved with order-to-delivery in five days versus three weeks, customer complaints resolved within 24 hours versus three days, and so on. Metrics this specific done for each customer force measurable goals. If they're too general, they become platitudes.

DC: New metrics have to be translated into new behavior as specific as the metrics. It's not good enough to leave it at "work smarter" or "think out of the box." The CEO has to get it to the point that it's clear what will be seen and heard when people are doing those things.

That is useful to get things going, but how do you maintain momentum?

GS: By being in a turnaround mode. To most people, the word "turnaround" means companies going out of business. Turning around money-losing companies is straight forward . . . eliminate things that lose money like loss-making branches and products, and you're a hero. Getting successful companies in a turnaround mindset has much more upside potential. It starts with clearly identifying sources of competitive advantage and then ensuring new behavior strengthens them. In successful companies, this translates

into stronger focus on the three or four heart-of-the-matter issues that will make the most difference.

DC: Brian maintained momentum by replacing senior people who resisted the changes that had to happen. It's not easy or pleasant but I've rarely seen a company that changed its personality without replacing people. Capabilities needed for the new strategy are imported and, as important, it sends a message that the boss is serious.

GS: It's like the old saying: Look to your right, look to your left, these people will be gone in a year. But sometimes the two people on your right and two people on your left are the ones who might be gone in a year!

Brian didn't do it alone. What can be learned from Carol's profile and how she worked with Brian?

DC: More and more, CEOs are talking about organization cultures, especially when they have adapted or inherited new strategies. Boards are hiring or firing CEOs based on their ability to change cultures. The problem is that neither most CEOs nor their boards really know how to work the culture side of the equation.

The top HR people should be able to help. To do so, they have to be comfortable talking about strategy and thinking strategically . . . understand power, not be intimated or discouraged by it . . . and they must be self confident enough to give the person in power hard feedback and deliver the toughest messages. They should become primary political advisors to the CEO, just as Carol was to Brian.

GS: The CEO has the loneliest job. He can't really open up to his board. The more Brian told them, the more anxious they got. His relationships with his direct reports have to be kept at arm's length. To whom can he bare his soul? To discuss "what ifs"? If he is lucky, he has a good friend and confidant . . . but most CEOs do not. To get the organization aligned with the strategy, the best person to talk to is the CHRO.

Conclusion

The most successful CEOs realize their organizations' and their own success are tied to their ability to adapt the organizational culture to meet new competitive challenges. The most important time to think through how to do so is when the strategy changes and new processes and new structures are put in place to make simultaneous improvements in speed, quality, service, and efficiency.

More widely understood now is that, during such times, success of the strategy depends on a change of behavior on the part of a critical mass of leadership. Most CEOs, like the leader we call Brian, did not study organizational culture or gain experience in their rise to the top to know what it takes to change.

For help, more CEOs are looking to heads of HR and inviting them to be central players as new strategies are developed and deployed. The good news is that HR people have sought this recognition for years. The bad news is that, in our experience, too many are unprepared to meet the challenge.

1. They have not developed a strong-enough strategic mindset, cannot describe the current strategy in such a way that their peers gain insight, and, most of all, cannot articulate convincingly enough the connection of the culture with the company's strategy.
2. They have insufficient stature and influence in areas outside traditional HR boundaries. They can be counted on for expertise in compensation, benefits, hiring, and so forth, but most are not seen as an integral and necessary voice when formulating a new strategy or in planning its success.
3. They have not thought through the vital-few parts of the culture that can be altered within the constraints of the new strategy. Although well-intentioned, programs to change behavior often miss the mark because they are not linked closely enough with operational programs to improve speed, cost, and quality.

We wrote this article because we perceive in our work with CEOs and boards of directors a vital but too-often unfilled expectation that employees will behave differently to meet the needs of a new strategy. With that expectation comes an unprecedented opportunity for Human Resources. To make the most of it, CEOs must demand of their CHROs capabilities that have not usually been part of their job descriptions to reflect the vital link between strategy, talent, and behavior. We foresee a time when one executive has responsibility for both HR and strategy; indeed, we have advised a few CEOs who are expanding the roles of their HR people to include strategy, IT, and/or innovation.

The best CHROs in the future will have honed their capabilities to think and act strategically and will be recognized by their peers in this area. They will be invited to the table, and will have earned a place there. They will have "called the question" in a way that the CEO and senior managers reconsider at deeper levels the strategies that must be implemented and, in particular, how the personality of their organization must change to ensure those strategies succeed.

BIOGRAPHICAL SKETCHES

Dan Ciampa is an advisor to senior leaders and boards of directors during CEO transitions. His most recent two books are *Taking Advice: How Leaders Get Good Counsel and Use It Wisely* (Harvard Business School Press, 2006) and *Right From The Start*, with Michael Watkins (Harvard Business School Press, 1999).

George Stalk is a senior partner and managing director of The Boston Consulting Group, Inc., and an adjunct professor of strategic management for the Rotman School of Management at the University of Toronto. He is the coauthor of a number of books, including *Memos to the CEO: Strategies in Our Future*. George is a frequent contributor to the *Harvard Business Review* and other publications.

Beyond the Boardroom:

Considering CEO Pay in a Broader Context

Steven Van Putten & Aubrey Bout, Watson Wyatt Worldwide

Executive pay is under more scrutiny than ever before. Although institutional investors may not agree, most boards do a good job of creating CEO pay plans that attract high-level talents and align performance to company objectives. Boards and compensation committees, assisted by CHROs, can improve how they pay CEOs by doing more to address the concerns of the many stakeholders affected by CEO pay packages. We include several best practices suggestions that can enhance CEO pay plans.

The Current Environment for CEO Pay

Although executive pay in general and CEO pay in particular have always been subject to external scrutiny and regulatory actions, never before has it been subjected to such intense reform efforts. The primary criticisms of executive pay are that CEOs are paid too much and that pay is delivered irrespective of performance. Although much of this criticism is deserved by only a fraction of the thousands of publicly traded companies, nevertheless, the effects of such public criticism have reverberated in boardrooms and have affected the design of executive pay programs. Boards are tasked with the difficult assignment of ensuring that pay is of sufficient magnitude to attract and retain the best talent and that it is structured to motivate and reward desired performance outcomes.

Beyond the boardroom, CEO pay structure and delivery affects many and varied stakeholders, among them employees, potential CEO succession candidates, shareholders and investors, and the local communities in which employees work. We identify considerations and best practices in constructing an appropriate CEO pay package that also considers these other stakeholders. We discuss the key external factors influencing, and in some cases changing, the design of executive pay. We then examine how the structure of CEO pay affects various stakeholders and identify best practices for ensuring that CEO pay is part of an organization-wide vertically aligned pay system. Finally, we discuss methods for evaluating the degree to which the CEO pay package achieves its desired objective.

EXHIBIT 1

Institutional Investors Believe the US Executive Model Has Overpaid Executives

	Institutional Investors		
Overall, the US Executive Pay Model at Most Companies	*Agree*	*Neutral*	*Disagree*
Has led to excessive levels of executive pay	86%	6%	8%
Has hurt corporate America's image	75%	11%	14%
Has created employee resentment	78%	15%	7%
Is an example of poor US corporate governance	54%	15%	31%

Source: Watson Wyatt 2008 Report on Boards of Directors' and Institutional Investors' Views on Executive Pay and Corporate Governance

Responding to the New Environment

Beyond traditional pay critics, comprised primarily of certain members of the media, individual public figures, and some academics, other parties have asserted their influence and power in an attempt to shape executive pay. These other parties include activist institutional shareholders and their advisors, hedge funds, and government entities such as the Financial Accounting Standards Board (FASB), SEC, IRS, and Congress, and institutional investors such as state and union pension funds and mutual fund companies. Institutional investors and their advisors, including Institutional Shareholder Services (ISS), Glass Lewis, and others, actively seek to change the way executive pay is delivered. Watson Wyatt research has found that institutional investors believe that the US executive pay model has overpaid executives (see Exhibit 1). Key areas they are pushing for reform are:

1. Targeting pay opportunity above market median, a practice they view as ratcheting executive pay upward;
2. Excessive severance benefits, which they argue represent pay for failure; and
3. Golden parachute excise tax gross-ups, which they view as providing excessive benefits to executives at the expense of shareholders.

The movement toward greater influence of outside shareholders on executive pay actions is also reflected in the "say on pay" efforts of some shareholder groups. Say on pay is a shareholder resolution effort targeted at giving shareholders an "up or down" advisory vote on executive compensation programs and practices. Whether this effort will result in any major, permanent changes remains to be seen, but already its effects are being felt in the boardroom.

Also significantly influencing executive pay are regulatory efforts by FASB, SEC, IRS, and Congress. Back in the middle of 2005, FASB mandated stock option expensing, which significantly affected stock options and employee stock purchase programs, neither of which required an expense prior to 2006. More recently, new SEC shareholder proxy disclosure rules have significantly increased the transparency of executive compensation, particularly by enhancing the disclosure of indirect elements of compensation such as supplemental retirement benefits, deferred compensation, perquisites, and severance arrangements.

Why should these external forces be so important to companies and, especially, their HR executives? The actions of these groups and their effects are visible to multiple stakeholders. Consider one example: The requirement to expense stock options and employee

stock purchase plans hit rank and file employees the hardest, as companies sought to contain this expense by reducing participation in stock option programs and cutting back or eliminating broad-based employee stock purchase plans. Consider this in combination with the new proxy disclosure rules, which provide employees with a clearer and more complete picture of CEO compensation. How did employee engagement suffer in companies in which they both lost their opportunities for stock equity and saw clearly, many for the first time, how much their CEOs really made? *Employees' positive perception of company leadership—a critical attribute of a successful organization—can be affected by any real or perceived misalignment in pay actions up and down the corporate ladder*.

Ultimately, the compensation committee and board of directors have the responsibility to determine the pay of the chief executive officer. For the most part, and rightfully so, the board seeks to align CEO pay with company performance and shareholder returns. Watson Wyatt research shows that the vast majority of boards do a good job achieving this alignment, but that does not mean that other stakeholders are not affected or should not be considered.

Key Stakeholders: Considering the Impact of CEO Pay Outcomes

In our experience, the compensation committee and full board of directors are primarily concerned with structuring a CEO pay package that accomplishes the following:

1. Attracts and retains high caliber talent;
2. Motivates the attainment of key performance objectives;
3. Aligns CEO interests with those of shareholders;
4. Takes into account shareholders' interests and is able to withstand public scrutiny.

Although not of primary consideration, the impact of CEO pay on other stakeholders can and should be taken into account in the design and delivery of the package. The CHRO should play a critical role in considering the impact of CEO pay on these other stakeholders. Key questions to be addressed can be found in Exhibit 2.

1. *Employees*. CEO pay sets the tone for the culture the organization is trying to create. If one of the key organizational objectives is to create an egalitarian, team-based culture, then special perks and benefits for the CEO and other executives are not the right approach. Rather, the CEO pay package should be structured around core incentives that are readily cascaded down into the organization. If the organization desires to foster a culture of meritocracy, then that should start at the top. Rather than spreading incentives evenly across the leadership team, strive to differentiate among executives, recognizing top performers. Although this is difficult to do with a 4-percent merit pool, larger cash incentive awards and stock awards can be disproportionately allocated to top performers. This sends a message of pay for performance that employees will more readily buy into, given the adherence at the top of the organization.
2. *CEO succession candidates*. The structure of the CEO pay package serves as a signal to potential internal (and external) successors. Take an organization in which the CEO's pay package is characterized by disproportionate weighting on fixed compensation elements, namely a high base salary, rich supplemental executive retirement benefit, and generous severance benefits. The signal to potential CEO successors is that of security. Such a package could serve as a self-selection device, possibly discouraging talented executives who are more attracted to a leveraged, pay-for-performance model. Contrast that with an arrangement in which the CEO has significant, performance-based incentives including a management stock purchase plan (MSPP). In an MSPP, the executive can purchase company stock on a pretax basis through a deferral of earned incentive. In exchange for forgoing a portion of his or her bonus, the purchased stock is matched with additional shares, for example, one share for every two purchased. This communicates to potential candidates that there is an opportunity for real "skin-in-the-game" for an individual willing to commit to the organization and place himself or herself at risk on the same basis as other shareholders.
3. *Industry competitors*. How can CEO pay be used to differentiate a company from its competitors? Can executive pay really be structured to provide a company with a competitive advantage? In our experience, compensation committees make their pay decisions on the basis of careful consideration of internal objectives and perspectives and marketplace practices. They know they need to be competitive to attract and retain talent, and they know their pay actions as detailed in proxy statements are subject to close scrutiny. Often, committees rely on competitive benchmarking to provide support for decisions on pay programs and pay levels. What if there was an opportunity to deviate from peer practices in a way that could serve as a key differentiator in recruiting talent and driving superior performance? As an example of this approach, Watson Wyatt research shows that real share ownership by CEOs leads to better company performance (see Exhibit 3).

   How can companies encourage greater CEO share ownership? One approach, as already discussed, is a management stock purchase plan. Another approach is to require executives to retain the shares they receive upon stock award vesting or option exercise, net of taxes. Still another approach is to create an incentive for executives to improve their share ownership by providing a "sweetener" on normal annual stock incentive grants if the executive exceeds a share ownership requirement by a certain percentage. When considering share ownership guidelines, think about requiring real share ownership. This would exclude shares still subject to vesting requirements, but would

EXHIBIT 2

Key Considerations for Stakeholders

Employees *What type of culture are we trying to create and how can we reinforce that culture?*	**Potential CEO Succession Candidates** *What signals do we want to send to prospective candidates?*
Industry Competitors *How can we structure pay to give us a competitive advantage?*	**Community** *How can we be more effectively viewed as a good, stable citizen?*

EXHIBIT 3

Companies with High CEO Stock Ownership Experience Better Performance

	Count	2006 CEO Ownership	Median 3-Year Cumulative TSR	Median ROE	Median ROA	Median One-Year EPS Change
High Ownership	544	$46,585,000	57%	15%	6.0%	16%
Low Ownership	544	$ 4,796,000	44%	11%	4.7%	10%
Population Median	1,089	$15,810,000	49%	13%	5.3%	16%

Source: 2008 Watson Wyatt Report on Executive Pay: Debunking Executive Compensation Myths

include shares owned outright, as well as the in-the-money value of vested stock options, which we consider a form of economic ownership.

4. *Community.* Although not typically top of mind in structuring the CEO pay package, the broader community in which the company resides is another key stakeholder. Strong, vibrant communities have a diversified mix of residents and businesses. Companies pay taxes to their communities, which are invested in schools and public infrastructure, and many make significant contributions to civic and charitable organizations by providing volunteers for nonprofit and professional organizations and direct financial contributions. Strong, stable companies also draw talented employees and their families to their communities, improving property values and supporting myriad local businesses. Communities are looking for stable organizations with responsible practices, and continuity of management is a key element of stability.

With CEO turnover at its highest levels ever, how do successful organizations use pay to foster stability of management? A good part of retention is realized through effective candidate recruitment. CEO pay structures can also facilitate the stability of leadership at the top. One such vehicle is career shares, which are restricted stock awards that vest upon retirement. Longer-term financial-based incentives can focus the organization on creating long-term value rather than solely on meeting quarterly analyst expectations, thus building long-term shareholder value.

Starting at the Top: Creating Organization-Wide Alignment of Incentives

The CEO's pay package sets the tone for the entire company's compensation strategy. To the extent feasible, the broader organization's compensation structure and benefits should be somewhat similar to that of the CEO. Aligning pay throughout the organization unifies all employees to achieve common goals. If the CEO or senior executive pay is not aligned and payouts are not linked to overall company performance, employees will view themselves as separate from management. Many employees will see that executives are not "walking the talk" and will become alienated, possibly resulting in poor overall organization performance. Excessive CEO pay often leads to inflation of other top executives' pay, which, in turn, translates into internal equity problems and results in poor team dynamics.

Alignment does not mean that pay levels are similar throughout the organization. Executives have a higher risk tolerance and a larger individual effect on performance than does the broader employee population, hence they should have a higher proportion of pay at risk. Following are some ways to help ensure organization-wide alignment with the CEO's pay package:

1. *As many employees as possible should be included in the pay-for-performance model.* Incentive programs for employees should mimic those of the CEO by creating a clear line between

2. The employee and company performance, the size of the reward, and the timing of the payout. Merit increases should allow for significant differentiation. Watson Wyatt research in 2004 showed that top performers received an average increase of 5.6 percent versus low performers who received a 2.5 percent increase. A 3-percentage-point spread simply does not differentiate performance enough—a top performer should receive an 8 to 10 percent increase and a poor performer should receive no increase. A top-performing employee who finds out his CEO received a 9 percent increase while he only received 5 percent will become disenchanted. Similarly, our research has shown that companies with more pay at risk that strongly differentiate between strong and weak performers through their bonus programs outperform organizations with minimal differentiation (see Exhibit 4 and Exhibit 5). In Watson Wyatt's 2005 Human Capital Index (HCI) study, companies that made substantial distinctions based on performance have five times greater total return to shareholders than companies that do not. Lastly, a number of studies have demonstrated that broad-based equity ownership motivates employees to create more shareholder value. A 2005 Watson Wyatt study showed that companies that had broad-based discounted employee stock purchase plans (ESPPs) rewarded shareholders with higher returns (see Exhibit 6).

EXHIBIT 4

Companies with More Performance Pay Outperform Others

	High Short- and Long-Term Incentives	*High Salary*
Salary as percentage of total rewards	63%	79%
STI/LTI as percentage of total rewards	13%	8%
Three-year total return to shareholders (TRS)	44%	25%

Note: TRS = stock price appreciation + dividends/beginning stock price.
Source: Ira Kay and Steve Van Putten, Myths and Realities of Executive Pay *(New York, NY: Cambridge University Press, 2007)*

3. *The overall organization bonus plan should generally employ similar metrics to those employed for the CEO and the funding percentage for the organization should be somewhat similar.* An executive bonus plan should pay out only if employees receive a payout. For example, at one company, the executive bonus pool was calculated at 90 percent payout whereas the broader employee pool was calculated at a 65 percent payout level. The main reason for the difference was that the executives were measured with a heavier weighting on financial performance whereas the broader employee population had a heavier weighting on operational performance. The compensation committee decided that it was inappropriate for the executive bonus pool to be funded at a higher level than the employee pool and agreed that the total pool should be funded at 77.5 percent (the average of the two levels). The committee agreed that going forward the executive and employee pool would be more similar, and that the company performance management process should adjust for individuals or groups who fell short of expectations (i.e., this would help ensure the executive leading operations and her group would receive lower bonuses).
4. *Stock incentive plans should allow for broad-based eligibility, but participation should be limited to top performers.* One way to promote vertical alignment yet still reward line-of-sight performance is to cascade equity participation on the basis of sphere of influence and scope of impact. For larger established companies, this can be done by employing a portfolio approach of stock options, performance shares, and restricted shares at the top of the organization, as the most senior executives have the greatest ability to affect shareholder value and financial results. The next tier of management can receive performance shares and restricted shares, as they still have the ability to affect financial results. Then, other high-performing employees can receive restricted shares based on attainment of line-of-sight goals that contribute to overall organization performance (see Exhibit 7).

EXHIBIT 5

Sharper Distinctions in Bonuses Are Correlated with Higher TRS

	High Differentiation Companies	*Low Differentiation Companies*
Bonus payout to high-performing employees versus low-performing employees	4.7	2.1
Market premium	30%	6.7%
Three-year total return to shareholders	47%	-2%

Source: Ira Kay and Steve Van Putten, Myths and Realities of Executive Pay *(New York, NY: Cambridge University Press, 2007)*

5. *The company should limit special awards and perquisites that are not linked to performance.* In many instances special executive perquisites can demotivate employees. Special parking, executive cafeterias, country club memberships, and private use of company aircraft are examples that can undermine the meritocracy culture that exists in most well-respected organizations.

Measuring the Success of the Pay Program

The success of the company's executive compensation programs can be measured in several ways. Key measures of an effective compensation program are the degree to which it is aligned from the top down, as indicated by the presence of many of the characteristics already described here, and how well it helps minimize the turnover of high potentials. Successful compensation programs need to be tied to best-in-class talent management programs such as rigorous performance management programs, focused leadership development training programs, and one-on-one executive coaching. High potentials need access to the best resources to further enhance their leadership skills and should be offered "stretch" career opportunities that diversify their perspective and skill sets. Successful organizations have a track record of identifying, developing, retaining, and promoting their superstars. These companies also allow for significant differentiation of high potentials by providing large base salary increases, significant bonuses, and 75th percentile equity grants. Best-in-class organizations have low turnover of high potentials and have a strong track record of promoting from within.

In addition to these outlined measures of success of a company's pay program, one measurement really counts for shareholders: The company should consistently generate higher levels of share price appreciation over the long term. Investors are expecting a specific level of return that is tied to the risk-reward profile of the company and industry. When a company's stock does well, rarely do investors complain about executive pay, whereas, when total return to shareholders falls below expectations, CEO pay and perquisites get carefully scrutinized.

EXHIBIT 6

Broad-Based Employee Purchase Plans and Higher Returns

	High	*Low*
Percentage of employees (other than executives) eligible for discounted ESPP	96%	0%
Market premium	63.8%	0.5%
Three-year total return to shareholders	57%	24%

Source: Ira Kay and Steve Van Putten, Myths and Realities of Executive Pay *(New York, NY: Cambridge University Press, 2007)*

Measuring Total Realizable Pay

The best way to measure the success of the executive pay program is to analyze company performance and executive pay simultaneously. Specifically, we need to assess how the company performed relative to its peers with regard to stock price and core financial metrics and relate this comparison to how much total realizable pay was earned. Total realizable pay represents the total actual cash compensation plus the current value of outstanding LTI awards (typically, in-the-money stock options, restricted stock, and performance share payouts) granted over a specific time frame (typically three years) using the ending stock price. This method contrasts with LTI pay *opportunity*, a more traditional analysis that calculates the value of the new LTIs as of the grant date, using the Black-Scholes value of stock options.

The organization's compensation programs can be deemed successful when realizable pay is aligned with company performance (see Exhibit 8). Specifically, Company A would likely be deemed to have successful executive compensation programs as the company over a three-year period experienced TRS at the 60th percentile of its peers while the CEO also received total realizable pay at the 60th percentile of the peer group. Other companies in the shaded area have similar pay-performance alignment. In contrast, Company O (top left) underperformed all of its peers while the CEO was the second-highest paid out of the 13-company peer group. There will be significant pressure on Company O's board to "fix" this misalignment. At Company U, the opposite is true: The CEO's total realizable pay is at the 20th percentile of the peer group while the company achieved results that corresponded to the peer 70th percentile. This will likely not be a sustainable situation because in a robust labor market Company U's CEO would feel underappreciated and could be lured away to a more lucrative opportunity.

The key takeaways here are that pay design, mix, and magnitude are ways to develop an aligned and successful compensation program. It is critical to develop a CEO pay program with a significant amount of pay at risk (a large portion of bonus and equity at risk). Too many restricted shares instead of stock options and performance shares might result in misaligned pay with potentially disastrous consequences. Lastly, the importance of minimizing turnover of high potentials and talented executive leadership cannot be overstated, as retaining top talent will help ensure that the company can sustain its high performance levels while continuing to enhance the company's reputation in its industry and local community.

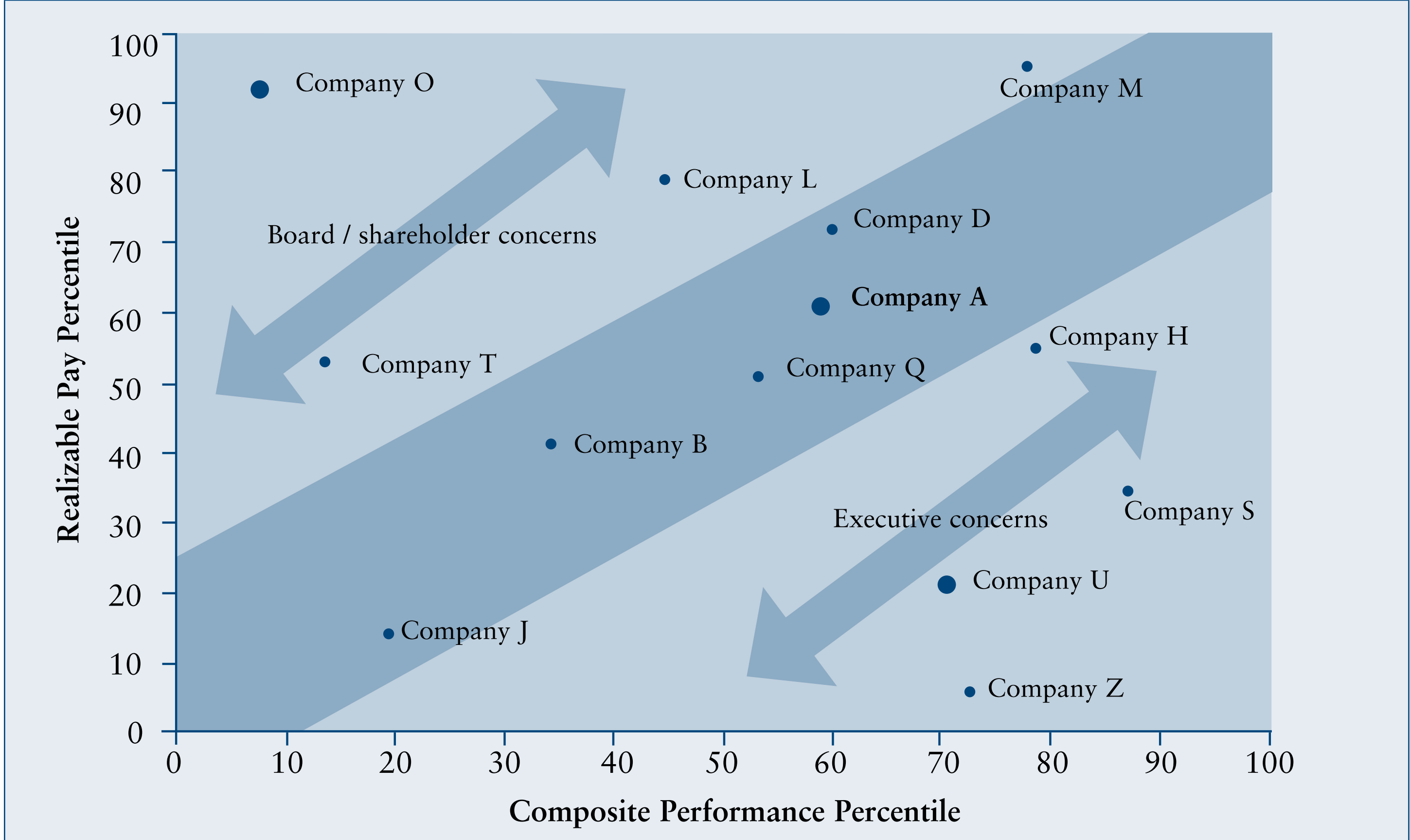
EXHIBIT 7

Vertical Alignment of Stock-Based Incentives

Level	*Recommended Vehicle*	*Rationale*
CEO and Senior Leadership	50% Performance Plan 25% Stock Options	■ Senior officers have more direct impact on long-term performance goals ■ Options maintain alignment and 162m compliance ■ Restricted stock promotes retention and positive cost-benefit
Vice President	25% Restricted Stock 50% Performance Plan 50% Restricted Stock	■ Mix of operational and strategic, yet still have influence on long-term performance goals
Director	25% Performance Plan 75% Restricted Stock	■ Less direct influence on long-term performance goals
Below Director	100% Restricted Stock	■ No direct influence on long-term goals ■ Restricted stock promotes retention and has high perceived value; awards based on performance

EXHIBIT 8

Pay-for-Performance Alignment



Conclusion

Clearly, when evaluating CEO pay, shareholder alignment and pay for performance are deeply ingrained in the lexicon of compensation committee members and the investing public. Much attention and energy are devoted to crafting a CEO pay package that retains, motivates superior performance, and aligns the executive's interests with those of shareholders; however, other stakeholders and other considerations can and should play a prominent role in the determination and measurement of CEO pay.

It is not much of a reach to predict that executive pay will always remain controversial. We expect that, in the future, executive realizable pay will continue to rise and fall with the performance of their companies. Recent regulatory changes and shareholder activism will lead more companies to revisit the structure of their executive pay programs, putting pressure on elements not directly related to performance—such as perquisites, supplemental retirement programs, and severance arrangements. We do not believe that moving to more responsible pay practices will not translate into lower pay; it could likely lead to higher pay, as, in a robust labor market, compensation committees will need to provide top talent with competitive compensation opportunities on a risk-adjusted basis. We predict this will lead to an increased emphasis on the core incentive programs, particularly incentives that focus on long-term company growth and stability and those that promote shareholder alignment through real and continued share ownership.

BIOGRAPHICAL SKETCHES

Steven Van Putten is the executive compensation practice leader for the east region of Watson Wyatt. He spends most of his time advising compensation committees and management on executive and outside director pay practices.

Aubrey Bout is a senior consultant at Watson Wyatt focusing on executive compensation. He has a strong track record of developing innovative compensation programs that align executive pay to business strategy and company performance.

Three Keys to CEO Succession: Expectations, Choices, and Integration

Constance Dierickx & Juleen Veneziano, RHR International

Analysis of data from 18 companies across industries and geographies argues for three key success factors in an effective CEO succession process: (1) alignment of the board around the organizational needs and resulting leadership requirements; (2) understanding of candidates in terms of fit, given these requirements; and (3) integration of the new CEO into the role and the organization. Taken together, these elements define a process companies can follow. The article recommends steps that increase the likelihood of a well-managed CEO succession, whether planned or unexpected.

No doubt about it, CEO departures create headlines, particularly when they are sudden, dramatic, preceded by poor company performance, or accompanied by scandal. Although globally the average CEO tenure is increasing, with a recent estimate at 7.8 years (Lucier, et al., 2007), the failures continue to capture our attention. The causes for these exits are numerous and varied—so much so, that boards might well wonder if they can effectively manage the CEO transition process, or merely endure it. Controlling all the variables is not realistic, but organizations can do much to improve the procedure, particularly if they see the process as continuous rather than episodic and view it as a dynamic interplay of context and person(s).

CEO selection, either for current or longer-term needs, presents a picture so complicated that one could hardly blame a board for settling on a few simple criteria and moving ahead. No small wonder that research indicates that although *54 percent of directors report having a plan for CEO transition, only 35 percent feel confident that such a change would be smooth* (RHR International Co., 2005, 2006). An organization's ability to achieve its goals is, however, inexorably linked with the capability and credibility of the chief executive officer. CEOs do not usually appoint themselves (founder/owners excepted). This most critical duty falls to the board of directors. Too often boards select and manage the CEO by "gut feel," and rely heavily on past accomplishments. Although achievement is certainly one indicator of a capable chief executive, it is far from the only criterion.

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Research highlights three stages of a thoughtful CEO succession process:

1. *Build* an aligned understanding of the organizational context and leadership requirements;
2. *Select* based on goodness of fit to the needs of the organization;
   a. Identify a pool of candidates (internal and external) and select based upon fit;
   b. Select for current needs and prioritize the development of internal candidates to provide for future needs;
3. *Integrate* to ensure a smooth transition.

Successful execution of this process requires involvement and leadership of the board; participation of the senior HR executive; willingness to do the difficult work of achieving alignment among the directors; a deep understanding of how the candidates will behave in the context of a given organization; and discipline to plan and carry out an integration process that includes attention to aligning the new CEO with the board.

In addition, beyond just relying on past experience and accomplishment, two other criteria are essential, though they often receive short shrift:

1. Subtle but important behaviors and their impact; and
2. Context, which is an amalgam of: industry particulars, strategy, perspective of the board, extent to which the board is aligned, organizational lifecycle stage, culture, changes required for success, and the array of constituents.

Build an Aligned Understanding of the Organizational Context and Leadership Requirements

Alignment of the Board: A Necessary Condition

Events of the past few years have forever changed the awareness and expectations of the corporate directors' role. Boards are subject to increasingly more stringent regulations, decreasing patience from investors, and continuous attention from analysts and journalists. They exist to oversee the interests of shareholders through their governance role. Boards are also subject to scrutiny for all manner of activities within an organization. Given the risks to shareholders and the board itself, they can ill afford to tolerate the mistakes that arise from a poorly executed succession process.

Alignment of the board is vital to a well-executed CEO succession plan, but an organization cannot just assume it exists. Gathering information about the organization and its key imperatives from the directors themselves provides an opportunity to identify areas of agreement and disagreement (and there are always both). Input from the senior executive team and other key stakeholders (internal and external) about the challenges facing the company and what it must do to succeed adds important data and further increases understanding about what the new CEO will need to deal with. Once the needs of the organization are articulated, discussed, and agreed upon, the characteristics of the ideal candidate are more systematically and logically derived. This allows the board to have a critical discussion about what they are looking for in a CEO and why. This links strategy and leadership competencies in ways obvious and critical.

For example, a few years ago, the authors began work with a company that had just removed a CEO whose tenure caused conflict, poor morale, and employee lawsuits. In support of the company's strategy, he was hired to be a "change agent" and set the financial house in order. He was successful in achieving the financial objectives and made all the right fiscal changes; however, his behavior during his time with the company was highly objectionable. The board realized, in hindsight, that although they clearly established what they wanted him to do, they took for granted that he would go about making changes in a constructive manner. They did not see the need to articulate that aspect of the job, nor did they set up ways to evaluate it. Next time around, they would certainly

not make the same mistake.

Most boards, when shown the data (gathered to create the Profile of Success™), are willing to do the work needed to clarify and address differences in how they define "what good looks like." They understand the folly of proceeding without agreement regarding the attributes they seek in a candidate and why. If, and this happens rarely, a board is unwilling to attend to its differences in a meaningful way, the consultant must articulate the consequences. In concert with the HR professional, it is possible to lay out the different logical consequences, given one choice or another.

A few years ago, a disagreement about whether or not to change the focus and name of the business slowed the CEO transition process of a client company. The board already had several candidates in mind, each aligned with various directors. The process was, for a time, in danger of becoming one of competing alliances. Fortunately the board members were far more invested in the company than in their favorite candidates. A realization that this dynamic was operating did not happen spontaneously. It took deliberate and systematic dialogue, though initially the directors did not recognize the need for it.

Organizational Character and Imperatives

Content analysis of several profiles underscores what boards, external constituencies, and senior team members from various industries describe as the most important aspects of what their companies and CEOs must do to grow shareholder value in ways that respect the strategy and culture of the organization. Although each Profile of Success™ is unique, a thematic analysis of the profiles of 18 companies representing a broad range of industries identifies several high-level themes. No organizations in turnaround situations are included in this analysis for two reasons:

1. In these cases, the organizational imperatives are clear and predictable;
2. The time for thoughtful process has passed.

The primary categories resulting from the analysis of the Profile of Success™ content are illustrated in Exhibit 1 (sample descriptions of each category may be found in Exhibit 2). RHR's research indicates that board members look for a CEO who understands the importance of, and knows how purposefully to build and maintain, effective relationships both internally and externally. This emphatically includes the relationship with the board. They seek someone who can be a credible and effective partner in their efforts to drive the business forward and create value for shareholders in a sustainable fashion. Further, this includes a shared interest in effectively managing relationships with various external constituencies, building the capability of the organization, and especially creating a pipeline of talent leading to CEO succession. Strategy development and execution (in terms of both top- and bottom-line growth and operational excellence) are of course critical, as is building or maintaining a performance-oriented and integrity-based culture.

As Exhibit 3 illustrates, organizational requirements tend to fall in particular combinations, which together describe the extent to which the company is market-oriented. Boards of market-facing companies are more likely to emphasize CEO capabilities related to driving aggressive growth and innovation, such as the ability to identify and critically evaluate opportunities for acquisition and scanning the environment for trends that illuminate emerging opportunities. Of equal importance is preserving aspects of the culture that currently serve the company well, even as it expands. As seen in Exhibit 4, focus on instilling (or maintaining) a performance-oriented culture during expansion and geographic dispersal has become a more prevalent organizational requirement as of late. This is especially significant in organizations that fuel strategic growth through acquisitions.

Boards of more operationally focused companies tend to place emphasis on both operational excellence and external relationships. Of interest are CEOs capable of insuring that the organization is performing at its optimal level by measuring and tracking key performance indicators. This includes seeking business leaders who can develop or implement systems and processes in support

EXHIBIT 2

Sample Organizational Requirement Descriptions

Organizational Requirement	*Descriptor*
Effective board relationship	Proactively builds and maintains effective relationship with the board
Effective external constituency relationships	Builds and maintains relationships with external stakeholders, represents the company in negotiations with external stakeholders, and understands how external constituencies affect performance
Bench strength & succession	Builds the bench so that the company is better able to respond to industry needs, changing demographics and shifts in the market; selects, deselects, rewards, and retains members of the senior team
Drive creation/ refinement of strategy	Develops, implements, and manages the business strategy to create shareholder value; ensures translation of strategy into clear priorities and resource needs; adjusts strategy to account for changes in the marketplace
Operational excellence & performance	Executes business plans in alignment with strategy, monitors quality of performance, identifies issues early on, and responds quickly and effectively
Bottom-line growth (efficiencies)	Identifies and evaluates short- and long-term opportunities for cost and capital reductions
Top-line growth	Identifies opportunities to optimize resource allocation for organic growth; implements strategies for improving productivity and profitability
Performance culture	Drives an organizational culture based on accountability at all levels of the organization

of operational excellence. In action and word, the CEO must also be able to balance the needs and manage the expectations of various internal and external stakeholders, including but not limited to: board members and other shareholders, members of the senior team, employees, and members of the business community at large (unions, regulatory bodies, analysts, etc.). Finally, boards of operationally focused companies are seeking CEOs who can build the executive bench so that the company is better able to respond to industry needs and changing demographics.

Assume the case of a company in the utility industry. Power generation is a highly regulated industry with multiple and varied constituents who probably have competing interests. Simultaneously, power generation requires excellence in operations with few errors and quick recovery from disruptions, regardless of the cause. A leader in this industry must be able to oversee operational excellence and build a culture of continuous improvement while keeping risk low. In addition, the leader must manage myriad stakeholder relationships from customers to regulatory bodies. Further, the requirement is to keep service levels high, costs low, and to find ways to generate cash from nongeneration sources (such as power trading). This role requires a leader who is knowledgeable about operations, but clearly able to select and delegate to those who manage day to day. This leader needs both the savvy and credibility to manage sophisticated audiences and the sincerity to address customers, if necessary.

Select Based on Goodness of Fit to the Needs of the Organization

Candidate Evaluation

When evaluating candidates for a key role, leaders often ask candidates who they are and what they have done. These questions are asked in the hope of getting at something harder to identify: Can the person do what *we* need and, if so, will it be in the manner right for *us*?

Methods to evaluate candidates range broadly, but include: looking at the resume; checking references; round-robins of interviews; and assessments of cognitive horsepower, style, and personality. In addition, organizations ranging from multinational search firms to solo consultant practices sell assessment services. Often they tout their certification to use a psychometric tool as the means to stare into the deep recesses of a candidate's personality. This can disclose interesting information, but what does it mean? It may, for example, reveal that the candidate is an introvert. So what? This finding, on its own, is of no value. The value of a good assessment is not in psychological profiling per se, but in genuine insight about what psychological and behavioral dimensions mean in the context of the business.

The most effective evaluation methods result in:

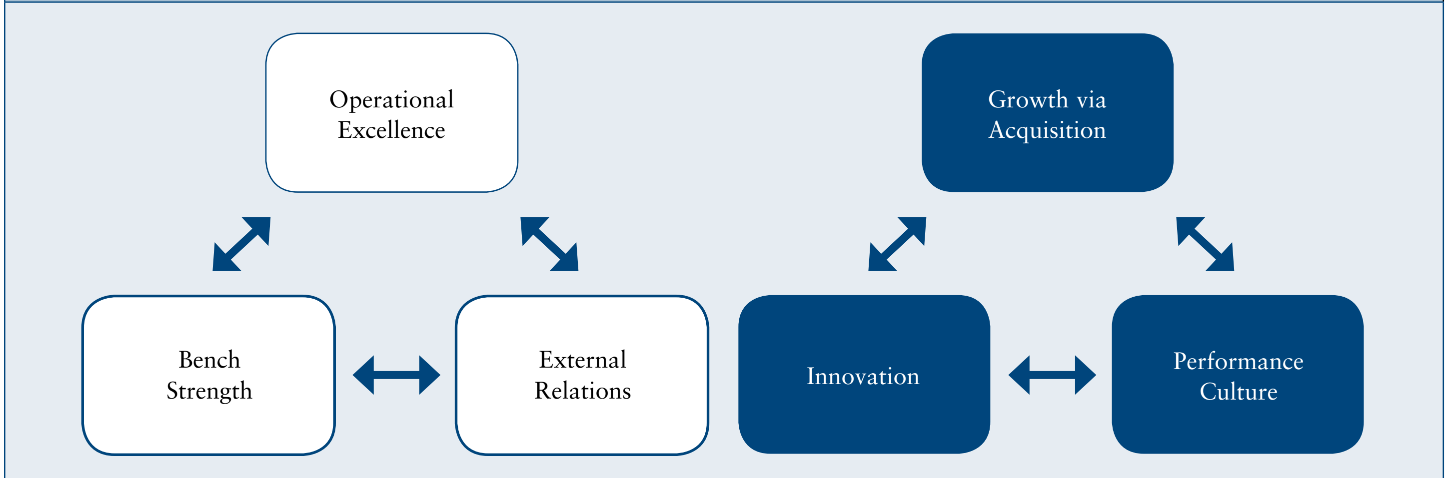
1. An understanding of candidates that synthesizes context and individual characteristics;
2. Accurate prediction about what candidates will do in the prospective organization;
3. Identification of questions for further discussion between the candidate(s) and the board;
4. Insights regarding risks associated with each candidate;
5. Defining the challenges to integration of the successful candidate and strategies to mitigate them;
6. Comparisons of candidates to the leadership requirements rather than each other;
7. Alignment of the board.

Can the Person Do What We Need?

The reality is that there is no perfect candidate, and trade-offs are made regarding the match between the candidate's capabilities and leadership characteristics and what the organization needs. For example, thematic analysis comparing specified organizational needs and CEO candidates' capabilities reveals two common areas in which there is frequently a match (candidate's capability fits the organization's needs): strategy implementation and execution; however, one area that greatly concerns directors is the ability to *develop* strategy, particularly where the company is looking to grow through acquisition. Further examination of the data reveal that boards are often concerned when candidate knowledge of the strategic landscape is neither as broad nor as deep as the

EXHIBIT 3

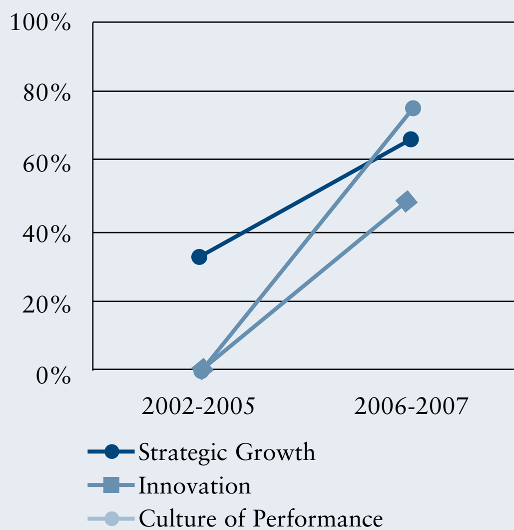
Organizational Requirement Profiles



organization requires. This concern is understandable, but another level of analysis is often helpful here. If the candidate is otherwise suitable but the experience base (past accomplishments) is not sufficient, the question is: Can the person perform anyway? The answer to this question requires unpacking the skills, attributes, and qualities that underlie the capability needed *and* predicting whether an individual will demonstrate the overall capability if he possesses the enabling elements.

EXHIBIT 4

Organizational Requirements: Increase in Prevalence (2002–2007)



Another common area of concern is a candidates' capability of improving the competitive positioning of the company. In situations in which this talent is unproven, boards often decide that a candidate is not a match with the organizational requirements. This may be correct, but it may also be that a discussion between the board and candidate regarding the perceived shortcomings will be fruitful. Further discussion may illuminate capability in the candidate that is not obvious given the resume. Should the board decide to hire this candidate, they are better positioned to understand the risks associated with doing so. Once the risks are more clearly articulated, discussions can take place about what risks are tolerable, how those can be mitigated, and who shall take what role in doing so. Should these discussions confirm that a candidate is not a match, no harm is done by this exploration.

Will It Be in the Manner Right for Us?

The underlying psychological characteristics and how they play out *within the organization* can make or break a CEO's effectiveness and tenure. Looking deeper at the data, at the behavioral level, factors underlying effectiveness are found. Common examples of this are:

1. Understands the importance of initial impact and presence; has a credible impact on internal and external stakeholders;
2. Exhibits sound judgment and decision making;
3. Views others' input as critical for informed decisions (related to the ability to build followership);
4. Exhibits both confidence and humility.

The research and experience suggest that the value in assessing candidates is greatest when the assessment is of the psychological characteristics *in sum and considered within* the organizational context. For example, one of the most frequently referenced leadership requirements is related to the CEO's having a credible presence and impact (both in terms of her initial impact and over the long term). Several dimensions underlie this characteristic, such as:

1. Effective communication (speaking and listening);
2. The ability to sense and respond appropriately to subtle interpersonal dynamics; and
3. The capacity to sense and respect the cultural norms of an organization (politically savvy).

The ability to perceive accurately and respond effectively to a range of dynamics is essential. Emotional maturity is also

significant, in particular when considering how consistent a person is across situations, even in the face of significant challenge.

Sound judgment and effective decision making are common leadership requirements, often described together. Effective decision making is driven by baseline cognitive ability and speed of processing plus the ability to balance the need for information with the need to act. This is a dynamic interplay for which no algorithm has been written, thus, the need for good judgment in different situations over time. Often boards speak about the need for the CEO to make the tough calls independently, take a stand when the situation requires, and recognize when others' input is needed. Knowing *when* to do *what* and getting it right most of the time is critical. Understanding whether this ability is based upon knowledge and experience only or a combination of experience and leadership capacity is important.

Once the successor is named and in place, it is tempting to breathe a sigh of relief; however, the integration process is complex and can last 18 months or longer.

Case Example: Young and Beautiful

When the board of a privately owned company in California was looking for a successor to the long-serving and much-admired CEO, they first looked at the next two levels down in the organization for candidates. Time was not a factor—the transition was planned for three years in the future. In a process well-defined and agreed to, they prepared an exhaustive description of the next CEO. It read like "walks on water." This was not unusual, as many such profiles are aspirational. The board knew that part of its task was to define the risks to the organization of each candidate, based on their weaknesses, relative to the Profile of Success™.

The process turned up four promising internal candidates. Three were two layers down, and one was a direct report to the sitting CEO. Each contender had a meeting with the board and discussed his aspirations, as well as the board's assessment of their capabilities. Each side was candid, with no punches pulled. But the board went further and provided needed support and resources to the key people for their development. Furthermore, they followed up on the individuals' progress. The actions of this well-functioning board made this a credible, relevant, and useful procedure rather than an exercise or paper drill.

Less than one year into this process, the incumbent CEO unexpectedly died. Though surprised and reeling from the loss, the organization swiftly named the direct report as successor and reminded those at the next level that their opportunities to demonstrate leadership were now greater. In the trio of candidates was a bright, thorough young leader with an impressive academic pedigree. Already looking the part—tall, well-dressed, and articulate—he had successfully turned around one of the company's business units in the previous five years. An additional asset was a fine appreciation for the financial aspects of the business—something that was lacking in the current CEO. Sounds good, right? Not so fast! A retired CEO on the board spoke clearly and directly about this wunderkind, saying: "He sure looks like the package, but he's missing an important quality—humility." Though not exactly arrogant, the candidate was nonetheless given to intellectual jousting matches that left people feeling manipulated. His way of influencing was to maneuver conversations with a prosecutorial style, and with a smile on his face. This combination of mismatched verbal and nonverbal style gave people the creeps. Although what he said made sense, he did not seek or listen to advice. His declarative way made it seem that he already knew all the answers. Often right in his business judgments, he nonetheless was challenged when it came to influencing his peers. If he were named the next CEO, he would need to build followership with those he was currently alienating.

Following a meeting with the board, the sitting CEO met with each of the three possible successors and a consultant. In each case, they talked about what development would be expected to remain in the successor pool. Two listened carefully, the third (the rising star) argued about how he was assessed, proving in real time the accuracy of the misgivings uncovered in the assessment process. He was removed from consideration. Though still leading his part of the company effectively, the CEO position was not in his future at this organization.

When the time came for the CEO to retire, the board reviewed the two remaining internal candidates. They selected the one who had most closely followed their counsel. He had demonstrated the willingness and ability to make the changes needed for success. The other aspirant was given additional responsibility and a vote of confidence by the board. He remains with the organization to this day and is a valued contributor.

Integrate to Ensure a Smooth Transition

The Choice Is Made—Now What?

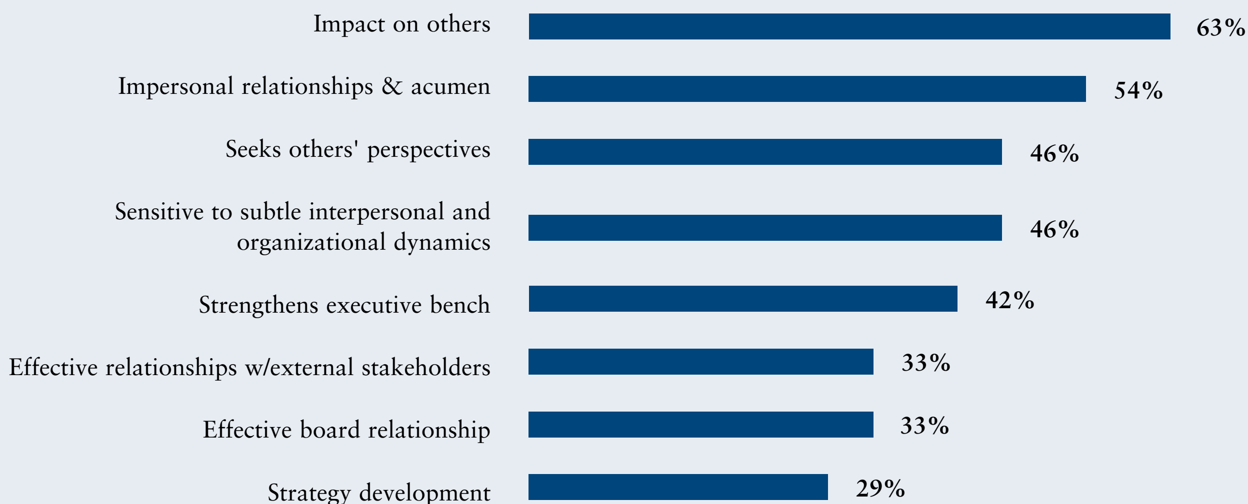
The process of CEO succession takes time and energy. When it is approached episodically, it creates the distraction associated with anticipation. Once the successor is named and in place, it is tempting to breathe a sigh of relief; however, the integration process is complex and can last 18 months or longer. A lack of attention to this transition time can result in the loss of a promising executive and, at worst, this happens after they create havoc. RHR's prior research on this topic examined the reasons for failure at the executive level. Those most commonly cited are:

- Failure to build partnerships;
- Unclear role expectations;
- Lack of political savvy;
- Failure to achieve two or three critical expected objectives;
- Excessive learning period.

Further, the research indicates that 41 percent of directors do

EXHIBIT 5

Percentage of Candidates Who Demonstrate Listed Potential Gaps During Assessment by Boards



not believe they pay significant attention to the integration of a new CEO with the board (RHR International, 2005) or to the strategic differences between the CEO and board, leading to rapid dismissal (Ertugrul & Krishnan, 2007).

Evaluation of candidates focuses on what they will do for the organization. For successful integration, the board must ask the same question in reverse: What will this candidate need from us in order to succeed? What will we need to do? Are we prepared to do what we need to do? Once again, the relevant issues are not merely about selecting the person with the right background and personality; they are also systemic.

The deliberations about a given candidate must include what and how an organization will address areas in which she is less skillful. A clear-eyed review of weaknesses and the risks they imply is essential.

When selecting a CEO, nothing prevents a simultaneous affirmation of an individual by offering the job and highlighting "watch out" areas. Doing so sets the stage for candor between the board and CEO, a critical factor in an effective relationship. Listed in Exhibit 5 are categories of common weaknesses observed in candidates for the CEO role. Although many are subtle, they are nonetheless important. It is not uncommon for directors to recall a seemingly small but nagging concern uncovered early in the process that, because of their inaction for whatever reason, manifested later as a major issue.

In the case highlighted earlier, preparation paid off in two ways:

1. It enabled the board to respond to an unexpected CEO vacancy, as well as a later planned transition.
2. The company retained the talents of key executives who were not selected as CEO.

This company's financial results are currently excellent, which the board believes is because of selection of the right CEO and retention of talented leaders.

In this example, the board knew that its chosen successor had some significant weaknesses that presented real risks. Board members took action to mitigate them by meeting with the new CEO and giving him some instructions and advice, including:

1. Directing him to take a fresh look at the organization;
2. Impressing upon him the need to build relationships;
3. Suggesting that he solicit the views of others;
4. Laying out their expectations for how they expected him to work with the board;
5. Strongly urging him to work with an executive consultant to create and implement a transition plan.

Summary

Chief executives' transitions capture our attention, and for good reason. CEOs are visible symbols of their companies, role models (for good or ill), and, at times, icons. They have broad influence—certainly within their organizations, but also well beyond. Furthermore, these transitions are not routine or frequent (usually). A board can benefit from the structural and procedural aspects of CEO succession discussed here:

1. *Build* an aligned understanding of the organizational context and the leadership requirements;
2. *Select* based on goodness of fit to the needs of the organization;
3. *Integrate* to ensure a smooth success.

Although these elements are important, do not mistake them for the total solution. The undocumented, interpersonal, and group dynamic processes are where much of this work takes place with the board. These include the dialogue, tensions, horse-trading, boundary setting, and self-correcting aspects of work at the board level. A well-functioning board can work through a clear process

without giving technique and details undue weight. A poorly functioning board will overrely on process or may delegate the results to others. Boards must work with facts; they must face those facts; and they must take a proactive approach to aligning CEO candidates and the needs of the many stakeholders of the enterprise.

For a meaningful process, the board, senior management, and those who offer advice and counsel should ask themselves these essential questions:

1. Are we seeing the organization as it is or as we wish it to be?
2. Do we have a complete and unvarnished view of the CEO candidates?
3. Do we have a clear process for getting the right person in the role and for managing a solid transition?
4. Do our group dynamics/culture facilitate or hamper us?
5. Do we make sure we challenge our own assumptions—with help from outside, when necessary?

Selection, management, and succession of the chief executive officer is one of the most important roles of a board of directors. Other than share price and market value trends, it is the most visible indicator of the effectiveness of the board. Directors are smart and experienced people, who are diligent and by and large take their responsibilities seriously. Why then, is CEO succession so challenging? Several reasons:

1. It is infrequent;
2. It is often a lengthy process with multiple, and at times competing, dimensions; and
3. The search for independent and expert advice and counsel is obscured by the lack of awareness that CEO succession is much more a board process than a project.

This leads to overreliance on procedures or habitual methods of succession and underutilization of a robust process that can be recalibrated frequently and relies upon the expertise of the board when providing guidance.

An effective process for managing succession requires discipline to execute correctly; however, the rewards for a well-planned process are plenty and the dangers of a poorly implemented one are too great to be ignored.

Research Methodology

This research includes a content analysis of 18 Profiles of Success™ and a thematic review of 12 matched sample pairs (Profile of Success™—Personal Development Guides™). All reports were developed between the years of 2002 and 2007.

The Profile of Success™ specifies the attributes necessary for success in the CEO role. The contents of the report are clearly linked to the company's strategy and identified leadership competencies. These reports are based on several data points, including interviews with members of the board of directors, the current CEO, senior team members, review of annual reports, proxies, 10-K reports, strategy documents, employee surveys, customer satisfaction data, analyst calls, and thorough field research that may include visits to various locations where the company operates, informal or formal discussions with employees, customers, or suppliers.

BIOGRAPHICAL SKETCHES

Dr. Constance R. Dierickx is a senior consultant at RHR International, and consults to boards and executives to improve effectiveness. She writes, speaks, and consults to companies across industries in the United States, Latin America, Europe, and the Middle East. She has consulted on numerous CEO successions and is currently conducting research on the topic.

Juleen Veneziano is a research consultant at RHR International. She is currently studying the influence of strategies and cultures on the risks companies will accept to develop future leaders. Ms. Veneziano is a PhD candidate at Northern Illinois University and is expected to complete her degree in mid-2008.

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Complexity, Diversity, and Uncertainty—The Shaky New Ground for CEOs

David Dotlich, Peter Cairo, & Stephen Rhinesmith, The Oliver Wyman Executive Learning Center

Top executives in multinational companies face a set of challenges that grow ever more complex. Today's CEOs and other senior executives differentiate themselves and their companies by demonstrating better use of "head, heart and guts" in their leadership skills and behaviors. The experiences of several companies make it clear that businesses shed light on how to assess and develop whole leaders who demonstrate capacity to learn, to face adversity with courage, to manage uncertainty and to lead with genuine empathy. CEOs can model these qualities in their own behaviors and challenge their HR executives to be more resourceful in helping to grow the next generation of top executives.

About two months ago, we met with the CEO of a major corporation, and asked him how things were going. Rather than giving us a typical response—“fine” or “good, except for problem x”—he responded with a sigh. He began talking about how his job never stops; how he is under incredible stress; how there is too much information to digest and too many decisions to make; how he feels as if he is losing touch with his people; how it is impossible to know the right thing to do. Obviously, we had caught him on a bad day.

He is a prominent CEO with significant business results, a global brand with huge equity, and a top-tier team around him. His complaints were revealing that day, but given his success we could only imagine how other CEOs less successful and resourced must feel.

Actually, we do not have to imagine it. In our work with top executive teams and interviews with multiple global CEOs and senior leaders, we have talked to leaders in a variety of industries about their perspectives on the complexities, diversity issues, and uncertain situations they face. We have found that the contradictions, challenges, and opportunities of the CEO role continue to multiply each year. Each day seems to bring a new complication, and the conflicting needs of investors, customers, employees, and regulators increase with globalization, technology, and interdependencies. They also worry that when they walk into the office or go online or answer their cell phone, a surprise is waiting that would force them to rethink plans and policies. It might be global financial uncertainty, lack of alignment in a matrixed organization, limited viability of a current business or profit model, or the increasing expectations (and options) of major customers.

In the August 20, 2007, issue of *Business Week*, Spencer Stuart’s James Citrin, who recognizes the growing and daunting challenges leaders face today, observed: “The job of the CEO has become so consuming and complex that if you could actually list all the things the CEO is responsible for, no human being can do them all.”

As stressful as the current business environment is, it also contains an almost sinful abundance of opportunities. New technologies enable convergence and connection; rapidly emerging global markets and innovative, breakthrough services and solutions all create strategic growth opportunities that never existed before. Taking advantage of them in a volatile, unpredictable world requires leadership that can make savvy decisions and move quickly even as the earth shifts beneath their feet.

Unfortunately, some leaders are more likely to become unbalanced by these seismic shifts than to think clearly, feel deeply, and act decisively. This is understandable, as a good percentage of today’s leaders have been selected, developed, and rewarded for a more stable time. In most companies, intelligence, fitting in, perseverance, and results, however short term, have been the ticket to the top. These are admirable qualities, but they are no longer enough. We have found that successful CEOs are using a range of leadership skills that constitute an almost holistic leadership style, not easily described by most corporate competency models.

Today, a lot of incremental, similar experience from the past may not be relevant in addressing current challenges; skills gained in a more stable environment may not produce the judgment necessary in the new complex, diverse, and uncertain business context.

In the past, gradual experience gained over time in a variety of situations was the best predictor of success in a senior corporate role. Companies defined and replicated effective leadership by investing heavily in competency-based leadership development parsing leadership behaviors and skills, assessing leaders against those behaviors, and prescribing experiences and assignments to produce those behaviors. Today, a lot of incremental, similar experience from the past may not be relevant in addressing current challenges; skills gained in a more stable environment may not produce the judgment necessary in the new complex, diverse, and uncertain business context.

We work as advisors to CEOs and boards on issues of talent and leadership in many companies and in many countries. We routinely hear that the intersection of media, regulatory bodies, shareholder activism, politics, and competition has created a dynamic playing field with almost unfathomable risk, complexity, and opportunity.

EXHIBIT 1

Clues for Growing “Whole” CEO Successors

Assess for a Series of Behaviors over Time that Demonstrate:	*Develop Through:*
■ Capacity to learn and change (vs. know) ■ Reaction in the face of genuine adversity ■ Courage to stand up against prevailing views ■ Willingness to act in times of real uncertainty or paradox ■ Genuine empathy with diverse people ■ Mesh of these qualities with the future challenges of a given company	■ Action-learning that tests as well as “teaches” through solving tough business problems ■ Job assignments that require degrees of risk taking and courage to succeed ■ Tying the right learning activity to those assignments ■ Coaching that helps leaders see the connection between head, heart, and guts—given future challenges ■ Leaders teaching other leaders to demonstrate these qualities

The recent credit and sub-prime lending calamity has exposed the global financial system as both risky and incomprehensible. Smart, experienced CEOs have lost their jobs because their skill and experience did not serve them in navigating the forced choice of lower returns or higher, almost unfathomable risk. Many CEOs have told us that if they had listened to their gut, they might have satisfied themselves with lower returns, even if their job was on the line for insufficient growth. Given the uncertainty before us, becoming a "whole leader" will become as important as experience in determining leadership success in the future. Using your "head" to anticipate, understand, analyze, and respond to new strategic directions, your "heart" to see the world from the perspective of a diverse range of stakeholders, and your "guts" to make tough decisions based on clear values will be the only leadership navigation tools that CEOs will have to make their way through the storms of uncertainty, diversity, and complexity that will constitute the environment for all future chief executives.

The CEO's Quantum Leap into a New World

In working with CEOs and senior leaders, they identify the following key drivers of uncertainty and complexity: global matrix organizations, increased regulatory requirements, information surge, rapidly evolving business ideas, disruptive technology platforms, and diverse employees and customers from around the world. At times, it appears as if no leader can know enough, feel enough, or do enough to manage this muddle. In reality, it is manageable, but the rising tide of new issues tends to make it seem as if too much is coming at us to do much about it.

Global Matrix Organizations

Most global companies today have evolved toward some form of matrix in order to remain responsive, innovative, and flexible. As a result, paradoxical choices and conflicting points of view emerge about everything from measurement systems to control issues to who gets credit and rewarded. How do you measure performance when many functions and individuals are vital to the outcome? How do you gain alignment or at least make sure everyone is doing what he or she is supposed to be doing when reporting lines overlap? Intellectually, most leaders grasp the value of matrices. Yet they also grapple with their diminished control of the work and their doubts that the time required for internal negotiation justifies the benefits. Moving quickly while also taking the time required for buy-in, alignment, and agreement confounds most leaders today.

We witnessed this in one global client who embarked on a new strategy to open retail stores for its global products. Global product managers, responsible for top-line global revenue growth, battled with store managers responsible for the same revenue in retail sales—over merchandising, product placement, and displays. Not an unusual story in matrix organizations.

Increased Regulatory Demands

Regulatory bodies have always existed, but more exist now, and they are more active, more conservative, more global, and more responsive to a growing number of consumer advocacy groups and politicians. Plus, they are often connected with each other, sharing information and becoming much more formidable opponents.

The Food and Drug Administration is a case in point. Year over year approvals of new drug applications are at an all-time low. Clinical trials in one country now inform the approval process in other, unrelated countries. Inspections of manufacturing plants, scrutiny of tax issues, OSHA and SEC reporting requirements are on the HR and CEO agendas every day. Politicians afraid of being challenged by the media routinely issue warning letters and requests for information to CEOs, often in response to what they read in the media they fear. It is fair to say that CEOs spend more of their time dealing with difficult regulatory issues than in the past, by attempting to shape the regulatory and political environment, and yet whether this time is well spent is unclear.

Most leaders feel they do not have the time to deal with all the regulatory issues, so how do they choose one over the other? Today they learn that one of their overseas country leaders is engaging in corrupt business practices; tomorrow they discover that they are being investigated for financial reporting violations. Organizations have always had opponents, but they are more numerous and more empowered than ever before. Leaders need to make tough choices about which ones are the most significant threats and how to defuse those threats—or proactively minimize them. All of this must be done while ensuring that their organizations avoid becoming risk-averse and reluctant to take the chances that are required to innovate and grow.

Information Flood

Although everyone is aware that we are inundated with data, what challenges leaders is determining where to focus. Which pieces of information are primary and which ones are secondary? How do you gain enough detachment and perspective to determine the patterns of information and decide what's important? How do you discern facts in the new avalanche of opinion? How do you know when enough information is enough and when seeking more will not make things any clearer. Information does not come "stamped" with a priority number. Most real threats to a business arrive as a weak signal on the horizon, or in customer buying patterns, or in the introduction of a new competitive product or service.

Today, the most critical information does not arrive in traditional ways. A rising chorus of dissent on blogs may be important, or a team member's first-hand observation from a developing market or a dense research report in an obscure scientific journal may be important. Leaders are trying to keep one eye on email, one eye on the Internet, one eye on the markets, one eye on global news, one eye on employee chat rooms . . . they all wish they had a second pair of eyes.

Rapidly Evolving Business Models

By the time leaders fully understand significant threats to their business model (how they make money, how they go to market, how they design their organization, how they select customers), it is too late. No doubt, Sony's leaders were convinced that the Walkman franchise would last for many years; they did not anticipate Apple's iPod. Blockbuster did not foresee the impact of Netflix; Barnes & Noble did not predict the impact of Amazon; Sears did not anticipate Wal-Mart's more attractive value proposition. Detroit obviously did not anticipate current consumers' concern with gas efficiency and the growing popularity of hybrids. The entire music industry failed to see the implications of file sharing and is still struggling to create a viable business model. In each case, success created real vulnerability. The speed with which business models evolve and dissolve today play havoc with a leader's best-laid plans. It is difficult to know when to change a successful strategy,

especially if it requires writing off significant capital investment, based on the intuition that, sooner rather than later, customer preferences will shift.

Apple's Steven Jobs is one leader who, because of earlier failure, recognized the new playing field; his company, despite building what some saw as the world's best PCs, would not be able or need to sustain that model if entertainment and content drove customer preference. Relatively few other companies were making software or add-ons for Macs, and a growing percentage of the market was demanding more software titles and connectivity. Jobs took the radical step of revamping Apple's business model on the fly, focusing on design, innovation, and moving from a highly independent, isolated organization to one that reached out to everyone from developers to competitors like Microsoft. In coaching CEOs and their teams, we have learned that much of their anxiety and concern is about the shortened lifecycle of any business model or engine today.

enhanced. Leaders must empathize and create trusting relationships with constituencies that influence them or that they have influence on, including employees, customers, competitors, suppliers, regulators, and foreign market representatives. As most leaders have come to understand, position power in a hierarchy is less significant than it ever was, especially when people trust the information they receive from their network more than information from authority.

In the face of these new complexities, what are the potential pitfalls CEO face? Look at the future environment and determine what is coming.

Potential CEO Pitfalls

The complexity catalysts cited here are having profound effects on CEOs. Sorting through a multitude of options, making tough choices, and leading in the midst of complexity pushes many CEOs into uncharted territory and reveals weaknesses that can lead to personal and organizational derailment.

On the most obvious level, senior executives make critical mistakes because they lack the necessary knowledge or curiosity. For CEOs and executive teams, we have found that the capacity to learn is a key predictor of the capacity to change. Many industries are now highly specialized, and the greater the degree of specialization, the more complex things become. Continuous learning is therefore a key requirement for leaders, especially those in specialized businesses. Learning at the top creates the potential to grasp enormously complex subjects; however, this requires time for the senior team to reflect on current trends and discuss strategic imperatives. In our experience, too many executive teams spend too much time responding to tactical issues and never reflect on the lessons they need to learn from the last fire they put out.

There is also a tendency for large corporations to adopt a group mindset at the top that is perilous. Perpetuating a standard leadership profile through well-designed selection systems and training programs that replicate "best practice leadership" is useful for attaining senior leadership alignment, but there must also be an eye to updating these profiles with mindset, skills, and attributes emerging in a rapidly changing world.

The recent sub-prime lending crisis has devastated financial services and many of their partners—not because leaders were "dumb" but because their shared conventional wisdom and experience told them everyone else was lending and repackaging debt securities and they had no choice if they wanted to remain competitive. In our post-mortems with financial executives, it is now clear how many had serious reservations about what was happening. Problems developed because lenders did not understand the risk portfolio of sub-prime loans, and, when the bottom fell out, they

> They also grapple with their diminished control of the work and their doubts that the time required for internal negotiation justifies the benefits. Moving quickly while also taking the time required for buy-in, alignment, and agreement confounds most leaders today.

Disruptive Technology Platforms

Technologies are converging—drugs with devices, cell phones with music, data, and television, home entertainment with security, diagnostics with treatment—and no doubt by the time you are reading this a slew of other convergences will have taken place. As a result, leaders have to rethink their businesses in uncharted ways because technology is leading them there.

When you can listen to your music, organize your calendar, watch television, and send emails on your cell phone, the conventional wisdom changes about all business. Leaders, though, recognize that they need to be careful not to overreact. One CEO we spoke with recently said that some of his best decisions were those he did not make. Although some aspects of a business have become disposable, other areas remain relevant. In the wake of disruptive technology platforms, it is not always easy to know which is which, or the speed with which convergence will actually happen.

Diversity as a Strategic Imperative

In the past, diversity programs were a defensive response to social inequities. More than that, diversity often was a highly politicized issue, with people divided into the haves and have nots. Contention, not collaboration, was at the heart of diversity discussions. The adversarial aspect of many diversity programs created discomfort, even among those who were supportive.

Today, diversity is more about influence with and the involvement of key stakeholders. The ability to identify with another person's perspective—a perspective that differs significantly from your own—is how relationships are built and collaborations are

were both exposed and unprepared. Health care, particularly those companies that enjoy large margins and unregulated pricing, may be next.

This also underscores the importance of effective *senior team functioning*. CEOs can no longer afford to have a senior team in which, as one of our clients recently expressed it, the "truth does not hit the table." This CEO said that one of his major responsibilities was to create a climate in which he was sure that his executive committee was engaged in truthful, transparent, and complete discussions of threats to the company.

The convergence of "experience" versus "judgment"—and ensuring that different people's judgment is expressed is a leadership necessity that will now dominate the conversation in many realms: politics, business, the military, government.

Given the complexity and uncertainty of the environment, a variety of successful business experiences, the predictive factor that drives so much succession planning today may be less valuable tomorrow. Too much of the wrong experience or knowledge can be a bad thing. Leaders who were raised from birth in a given industry or have been with one company for years may not see the sudden shifts in front of them, or may not be inclined to take the risky path of saying "yes." Experience in the crucible of "do or die" start-ups, enduring gut-wrenching values dilemmas, surviving significant failures, or managing through painful downturns may now be the best predictor of future success, but it will also need to be tempered by CEO judgment to anticipate, time, and execute appropriate decisions.

Colgate-Palmolive is one of the most successful consumer products companies in the world. Under the leadership of former CEO Reuben Mark, the company established a nearly unparalleled track record of growth over the past two decades. Yet the new CEO, Ian Cook, recognizes that the challenges of leading today are different than in the past and require different capabilities. He is challenging Colgate leaders to find the right blend of skills between the "old" model that served the company so well and new competencies that will be required in the face of challenges unlike those of the past. He knows that the company must maintain its financial strength, ability to execute, and the strong values that have made it successful while becoming faster, more innovative, and even better at translating consumer needs into new products.

We do not have a simple solution to the growing complexity issue except to recognize that successful leadership will continue to evolve and look very different from the past. No formula exists that reveals how much information is too much or too little, but we believe that "whole" leadership, that is, using their head, heart, and guts to anticipate and deal with the future, can insure leaders against the risks created by this new world. Leaders need their head to understand the evolving complex industry trends, their heart to put themselves in the shoes of different customers and competitors, and their guts to change their assumptions about their business models. And they need the guts to question conventional thinking, however logical and longstanding.

Look at each of the issues of complexity, diversity, and uncertainty independently and examine their implications for CEOs and other leaders today.

Analyzing Complexity—and More

As much as complexity seems purely like a head issue, heart and guts will be required to deal with the problems it presents. CEOs who handle complexity best are those who use a framework or filter to manage paradox, ambiguity, and other intricacies. They possess a way of viewing the world that allows them to strip away a lot of distracting and confusing elements of complex matters. They work to create an aligned senior team around a shared point of view that enables the whole organization to focus in a way other leaders cannot. And they use their heart to forge the trust that can keep a team together and take action in the midst of paralyzing complexity.

Johnson & Johnson is a company that is experiencing as much complexity as any other large global pharmaceutical and device manufacturer—regulatory requirements, fast-changing technologies, pricing pressures, growth in developing markets, and almost ongoing litigation. What does the CEO, Bill Weldon, do in response? Gather the top hundred leaders in an intense, three-day discussion—to review, debate, and align around their corporate credo. He knows he cannot teach his senior leaders everything they will need to know to manage the new complexities, but he also believes that building and keeping trust with key constituencies will be critical for the future. His view is that leaders who combine head, heart, and guts in a shared point of view about the J&J credo will do better in managing the new complexities than leaders who are rigorously trained in the latest analytical tools and business acumen.

Empathizing with Diversity to Build Insight and Trust

When leaders are not empathic, they have difficulty building trust. Some CEOs make the assumption that they can talk people into trusting them; that if they communicate how much other people and their goals mean to them, trust will naturally follow. It does not. Empathy is necessary to create strong relationships, and only when relationships are solid can trust emerge. Organizational leaders cannot impose their beliefs and structures on others and expect trust to flourish. Many companies fail to respond to new demands from employees and customers—a transparent, open relationship that takes account of unique individual needs—because they do not have the capacity or take the time to put themselves in the other person's shoes and gain the necessary insight into their perspective that will allow people to trust them.

Just as complexity sounds like a head issue, diversity topics like appreciating and understanding others from different cultures sounds like all heart. Again, though, the other two elements of whole leadership are crucial. Strategic diversity is difficult to achieve unless leaders have analyzed the needs of various stakeholder groups. They are not going to achieve meaningful diversity unless they have the guts to implement real change in hiring, promoting, selecting, and managing the performance of other leaders in the organization to live by a clear set of values.

It is ironic that as the world of work becomes increasingly diverse, leaders still grimace when you mention the word diversity. To them, the word connotes uncomfortable initiatives, political correctness, and forced rules. Diversity is not going away as a critical challenge for CEOs, but it must be viewed beyond internal diversity. Viewing diversity strategically requires understanding other cultures and stakeholders, demonstrating real empathy and understanding of community concerns for sustainability and economic development, and taking risks to do things differently in order to build the strategic alliances, coalitions, and relationships necessary to manage effectively in a complex world.

Nike is a company with enormous future growth in China. Millions of Chinese consumers are learning the fun of sport, the

pride of winning, and the powerful attributes of the Nike swoosh on shoes and apparel. To get ready for explosive growth, Nike's leadership programs are being conducted in China, its board of directors is meeting in China, and its employees are immersing themselves in China as an Olympic venue. For Nike, diversity is bringing the Chinese into the US heart of the company. That is managing diversity strategically!

Developing a Clear Vision and Values for Uncertainty

Every day seems to bring more uncertainty, unpredictability, ambiguity, and paradox into our work lives. Risks—financial, strategic, brand, and project risk—are multiplying. We seem to be in a continual media campaign of popular culture, conflict, and constant information. No leader or company can get enough information before making a truly good decision because, in the short space of time between making a choice and implementing it, new data points are born and may render the choice flawed. Competitors emerge out of nowhere (especially in developing markets and sometimes with only incremental improvements on your own product). Technology innovation renders a huge capital investment obsolete. A customer acquisition model, such as a large sales force, that has served a company well for years becomes an anachronism seemingly overnight as people move to the Internet for information and increased purchasing power.

Consider uncertainty within the context of growth. For many years, major corporations could grow with some predictability by process improvements, reinvestment of cost efficiencies, and acquisitions that yielded predictable returns. Growth through these and other traditional means no longer work—or at least not as well as before. The number one question on the mind of almost any CEO today is "Where is growth going to come from; and how is it going to be sustained?" Having an answer to this question will mean the difference between a short and long tenure for almost any CEO.

Perhaps the biggest challenge of uncertainty for companies is that definitive answers have become rare. It is difficult to know with any degree of certainty if a strategy will be effective, even if it has been effective in the past. Whether a younger generation of employees will be motivated by the same things that motivated an older generation is now unclear. No matter how much research or resources a leader has available, she cannot be certain in making decisions at the level she would like. It is entirely possible that, in a fast-moving world, something will take place in the next day or the next minute that will render that research obsolete or make those resources insufficient.

In a CEO Briefing survey published in the January 2007 issue of *Economist Intelligent Unit*, global executives were asked to state their challenges dealing with emerging markets, and one of the telling responses was "unfamiliar customers." Over 25 percent of respondents said that lack of insight about customers in emerging markets constituted an obstacle to growth in those countries. Given that more and more companies will be targeting more and more emerging markets, this statistic suggests that leaders do not know their new customers as well as they should. It also implies that they are not quite clear on how to get to know them.

Perhaps the most compelling uncertainty is that a CEO's tenure is shorter than it has ever been. According to a March 2008 study by Weber Shandwick, CEO departures at the 500 world's largest revenue firms jumped 10 percent in 2007, and CEO turnover rate is returning to the all-time high levels of 2005. The average CEO's direct reports are also more likely to leave after a shorter stay with the company. As a result, the senior management team is often in flux. CEOs today endure a higher level of job uncertainty from anxious boards, critical investors, and networked, online employees—all judging performance with almost daily scorecards.

In dramatically uncertain environments, leaders frequently make mistakes. Perhaps the classic one—and one we are seeing a lot more of—is transactional leadership when transformative leadership based on clear vision and values is required. Many leaders make the mistake when confronting paradoxical or conflicting options of seeking even more data, examining more reports, and building a rational case that often consumes time, seems too cautious, and usually results in incremental change. This tendency to be overly cautious is a common leadership derailer triggered when no clear answers to questions exist. (See our earlier book, *Why CEOs Fail*.)

> No formula exists that reveals how much information is too much or too little, but we believe that "whole" leadership, that is, using their head, heart, and guts to anticipate and deal with the future, can insure leaders against the risks created by this new world.

When grappling with uncertainty, many leaders make the mistake of pushing decisions elsewhere. Others become enmeshed in the data, trying relentlessly and often unsuccessfully to unscramble a mammoth helping of information and find some certainty in it. Still others opt for the "close-your-eyes-and-point" method of making a choice, ignoring the data and figuring that one decision is as likely to be right as another.

Making decisions in the face of real uncertainty requires guts. At the top of large hierarchies, many choices tend to be almost equal in terms of clear advantages. Only clear long-range vision and solid values navigate the waters of equally palatable alternatives. Guts is not all that is required. CEOs must also use their heads when dealing with uncertainty, especially when it managing risk. Although risks cannot be reduced, the odds can be managed. Whole leaders are highly knowledgeable about the risks they are encountering, and the values that guide them and their organization. If their course of action proves to be too risky, or strays too far from their values, they have ways of monitoring these deviations and have the courage

to correct their course, making their company less vulnerable.

Heart can also prove valuable in managing uncertainty, in that strong relationships can provide a buffer against unexpected events. CEOs who build and maintain relationships have an ear to the ground; if a runaway train is rushing toward them, they are likely to hear it. When leaders have people with whom they experience real trust, they create a real differentiator in a highly volatile environment. This can also provide them with a foundation for making tough decisions when everything else around them is uncertain.

Andrea Jung, CEO of Avon Products, led her company successfully for five years. She refurbished a tired brand, expanded its global footprint, and delivered financial performance that delighted Wall Street. All of this was accomplished while delivering on the promise of making Avon the "company for women" and delighting employees with her emotional as well as intellectual acumen and vision. Then in 2005 the company's performance slipped dramatically with problems in major markets like the United States and China. The solutions to the company's problems were not obvious, and exactly what needed to be done was unclear. At a pivotal moment during that period, when the pressure to respond was at its peak, a colleague advised her to go home for the weekend and come in Monday morning as if she were a new CEO brought in to fix the business. She responded to this challenge with just the right combination of head, heart, and guts. She dug into the analytics to figure out what had gone wrong. She reached out to her executive team and employees to get their perspective on the problems and to engage them in developing the solution. Perhaps most important, she showed the courage to make tough decisions such as de-layering the management ranks of the company, bringing in new talent on her executive team, and changing her own role as CEO to get more deeply involved in the operations of the business. Now three years later the company is again performing well and is better equipped to deal with future challenges than it has ever been.

Because it is impossible for CEOs to know, feel, or intuit all the answers to the challenges they face today, their capacity to develop other strong leaders around them may be the single most important task they have to face.

What CEOs Need to Know and What They Can Do

Our descriptions of the complexity, diversity, and uncertainty are meant to foster awareness and understanding CEOs, not fear and trepidation. As challenging as it is to be a CEO in this environment, it is also possible to thrive; however, to do so, a CEO or other senior leader must embrace these trends and develop new leadership skills.

CEOs often have problems addressing complexity, diversity, and uncertainty because they see them as transitory. They do not face the issues these trends raise either because they do not understand them completely or because they harbor misconceptions about them. Everyone knows we live in a complex, diverse, and uncertain world, but few stop and think about what these words mean in terms of leadership, especially within large organizations.

Two years ago we published a book based on extensive research titled *Head, Heart and Guts*. The thesis of the book, as the title suggests, is that effective leaders are whole leaders, who use their head to set strategy, their heart to connect with the world, and guts to make instinctive and intuitive decisions based on clear values. Since then, and despite the book's wide acceptance as a leadership model by a number of large global companies, we still too often see top business executives attempting to solve problems or seize opportunities using only their heads . . . or their hearts . . . or guts. We have learned that no matter how smart you are, you cannot outthink every problem; that no matter how empathic you are, people skills will be ineffective to deal with complex trade-offs; and no matter how quick you are to roll the dice and take action, getting things done may not grow or move the business if they are the wrong things.

For this reason, just understanding complexity, diversity, and uncertainty is insufficient for CEOs. They will need to develop whole leadership skills, both for themselves and for their companies. Most leaders continue to be developed through learning and training processes that never take whole leadership into consideration. Business schools and executive education programs focus on developing head skills or organizational development processes emphasize team-building and conflict resolution, essentially heart skills. But no one has figured out how to develop real guts in leaders today. Many coaches focus on requisite people skills, and many companies focus on job rotations to broaden experiences and hopefully create whole leaders—but the challenge today is to produce whole leaders who can face into complexity, diversity, and uncertainty with confidence and capability. This may be the most important item on a CEO's agenda. Because it is impossible for CEOs to know, feel, or intuit all the answers to the challenges they face today, their capacity to develop other strong leaders around them may be the single most important task they have to face in building the capacity of their company to meet the future demands we are discussing.

From our experience, there are three actions CEOs need to take to ensure their companies are prepared to meet the challenges of complexity, diversity, and uncertainty:

1. *Assess current and future leaders as whole leaders.* If past success is not an adequate predictor of future performance, new assessment methods and criteria need to be developed that identify leaders who possess the character and judgment to succeed in the future context they will encounter. Determining what combination of intellectual intelligence (head), emotional intelligence (heart), and moral intelligence (guts/values) will be needed for leaders successfully to lead corporate transformations that will be necessary for companies to survive and prosper in this

EXHIBIT 2

Three Key Challenges

1. How will we assess whole leaders?
2. How will we foster learning rather than "knowing" at the top?
3. Can real empathy, appreciation, and understanding of others be learned after childhood? If so, how?

new world will be a key responsibility for CEOs and their HR leaders. We are working with many CEOs to crack this nut: to assess whole leaders against future strategy, not past business performance, and against a global, not a local, world.

2. *Foster learning rather than "knowing" at the top of most organizations.* If managing complexity and uncertainty requires openness and flexibility in thinking rather than stockpiling data and information, CEOs will need to coach, mentor, encourage, and help their senior leaders to foster curiosity and openness to "think outside the box." In our experience with top teams, action learning and coaching that combines strategy insight, self-awareness, and new experiences can develop executives' capacity to learn more rapidly in a changing world. We work with senior teams to help them stay on their "learning edge." Job one for many CEOs will be to create an environment and culture at the top that allows ensures constant learning for the senior management team.
3. *Focus on character and judgment as well as business acumen and performance in developing new leaders and organizational culture.* Whole leaders do not thrive in a partial leadership environment. Head leaders who need to be the "smartest person in the room" will drive out intelligent, talented future leaders. Heart leaders who do not challenge themselves and their organizations sufficiently will drive out achievement-driven, results-oriented leaders needed for success. Guts leaders who focus on growth and performance at any cost ahead of character and values will find themselves with successful organizations vulnerable in an complex, diverse, and uncertain world.

   Is backpacking in Africa as a teenager a better predictor of a global mindset and future success than generating ROI improvement in the last global business role? If the diverse world of the future requires "heart skills," how will leaders open up, connect, put themselves at risk, and learn to appreciate rather than judge that which is different? One starting point is for leaders to model themselves after a successful, impactful CEO who shows the way.

Most CEOs recognize the need for whole leadership. Their challenge, and the challenge for all of us, is to move fast enough to develop whole leaders who can adequately address complexity, diversity, and uncertainty to prevail in this new world.

BIOGRAPHICAL SKETCHES

David Dotlich, Peter Cairo, and **Stephen Rhinesmith** *are the founding partners of The Oliver Wyman Executive Learning Center, the leading provider of customized senior-level action learning programs. Dotlich was HR executive vice-president of Honeywell International. Cairo was chair of the Counseling Psychology Department at Columbia University. Rhinesmith was former special ambassador to the Soviet Union and CEO of several global companies. They advise CEOs and boards of large global companies such as Johnson & Johnson, Novartis, BP, Nike, Avon, Doosan, Sara Lee, Colgate, National Australia Bank, Merck, Saudi Aramco, KPMG, and Bank of America on issues of talent and leadership. They have coauthored eight books, including the forthcoming* Complexity, Diversity, and Uncertainty: How to Lead When You're on Shaky Ground *(to be published by Jossey-Bass, January 2009).*

Speechless: The Erosion of Free Expression in the American Workplace

Author: Bruce Barry
Publisher: Berrett–Koehler Publishers, 2007

Reviewer: Jonelle Roth, The Eli Broad Graduate School of Management, Michigan State University

As you read Barry's book, you might wonder whether we live in 2008 or Orwell's 1994. The author describes a frightening workplace trend of silencing employees who exercise what most people consider their constitutional right to free speech; however, this book shows that the concept of free speech taught in schools is a rare commodity in business organizations. Using many examples, such as termination because of an employee's bumper stickers or refusal to attend a pro-war rally, we are shown that workplaces do not have to abide by the concept of free speech. Most employees are hired "at will," meaning they can be hired or fired for no reason, including what they advocate.

The employment at will concept has exceptions, including the National Labor Relations Act and Title VII of the Civil Rights Act of 1964. More recent legislation protects the speech of whistleblowers. Businesses (particularly, private corporations) do not generally need to permit free speech by their employees, whether on company premises or off, on company time or off. This issue may seem one of legal debate or philosophical discussion, but many management and HR issues are tied up with this topic.

First, as the author presents, part of free speech is due process in an organization. Research has shown repeatedly that employees are more satisfied with their organizations and feel more committed to them when they feel fairly treated. Due process questions can be related to hiring and firing, performance appraisal, promotion/demotion, and compensation decisions. If negative HR decisions are made because an employee supports another political party than senior managers do or because that employee has a different religious belief, then free speech becomes an HR issue.

A second set of concerns addresses Human Resources as change agent. Because HR is often in the unique position of a go-between for the employee and the organization, it has the opportunity to promote free speech and encourage senior management to view allowing expressions of free speech as supporting employee rights and justice; however, HR managers typically see their roles as legal watchdogs and hence take more conservative paths, which can lead to employee termination for things such as pseudo-anonymous blogs about their jobs, politics, or faith.

This book is a detailed, well-written, thoughtful and thought-provoking examination of the status of free speech in the workplace. It might seem a stretch as a topic for many managers, but I would challenge you to read it and engage in the debate over the question of whether organizations should permit or squash free speech.

The Craftsman

Author: Richard Sennett
Publisher: Yale University Press, 2008

Reviewer: John Beck, School of Labor & Industrial Relations, Michigan State University.

According to sociologist Richard Sennett, our contemporary world will be well-served by a reclamation of the notion of craftsmanship, doing "a job well for its own sake." In his new book, *The Craftsman*, Sennett posits that we are missing the valuable lessons that material culture, especially in the true marriage of head and hand, can present. He believes we must move beyond being ruled by the sheer "we do it because we can" mentality, available through scientific and technological advances, toward a more thoughtful melding of theory (head) and practice (hand) in all our endeavors, whether in the production of violins, medicine, computer programming, or other pursuits. Sennett is no simple Luddite, calling for an end to technology and a return to simple handmade arts and crafts. Instead his analysis stresses that we all can be better served by an ethic of craftsmanship, which will return us to a greater understanding of choices and consequences in how we produce goods and services and how we as consumers view them.

Sennett draws on an interesting diversity of historical and contemporary examples of craft to illustrate his thesis. He travels back and forth from the Manhattan Project to the brick makers of ancient Rome, from the guildhalls of Europe to the world of Linux programmers, and many places in between. He explores this reclamation of craft and explains that we are not limited in our craftsmanship by the lack of ability. Rather, he believes that craftsmanship is a set of principles and relationships (like intense concentration and empathy) all people can apply to any job or task.

Sennett argues that the physical nature of craftsmanship must not be lost. Physical interaction yields great understanding that cannot be achieved in any other way. The craftsmen who spend a long time understanding context, such as the nature of wood (knots, colors, and grains, etc.), have an advantage over the limitations of computer-aided design. He asserts that CAD use in architecture often ignores how the plan must work within the site. Looking at such factors as light, heat, and traffic, with a longer, slower involvement on the ground, would yield the designer a better way of understanding.

Though readers may be frustrated by the book's grand sweep and the author's lack of attention to direct workplace or societal policy alternatives, Sennett's aim in this volume is not to give a point-by-point plan, as much as it is to hold up a valuable mirror to our thoughts and practices. This book challenges our thinking and understanding concerning how we create work and workplaces, and how we make social and political choices about what we produce and consume. Sennett reaches out to the craftsman in all of us.

Must Read Worthwhile Skim It Bottom of the Stack

Leadership Brand: Developing Customer-Focused Leaders to Drive Performance and Build Lasting Value

Authors: Dave Ulrich & Norm Smallwood
Publisher: Harvard Business School Press, 2007

Reviewer: Michael L. Moore, Professor of Human Resource Management and High Performance Work Systems, Michigan State University

Dave Ulrich and Norm Smallwood have been bringing out a new book roughly every other year since 1999. In recent years their focus has turned from competencies to value propositions, results-based leadership, and now to the importance of intangibles. As their thinking evolved, they developed several important insights that ground this book.

One key insight is that leaders matter, but leadership matters more because it is not linked to a person but instead is the process for creating more leaders. Ulrich and Smallwood believe leaders must create a leadership brand based on seeing customer expectations translated into employee behaviors. A focus on the expectations of customers and investors and key stakeholders, as well as those of employees, enables leaders to build a brand that is anchored in the right knowledge bases, rather than on internal issues that dominate so much leader development.

Ulrich and Smallwood believe branded leadership can be developed. Successful brands require leaders who can model the behaviors, such as exceptional customer service, embedded in the brand. Further, leadership brand is not only a business construct. It is relevant for nonprofit organizations too.

The authors note that all organizations have a leadership brand, whether consciously designed and crafted or simply developed as a part of a muddling through process. Most importantly, these brands can be changed, and leaders can change their personal leadership brands. Successful leadership not only depends on a personal journey but also requires organizational journeys and feedback from external constituencies.

Ulrich and Smallwood supplement their ideas by interviewing recognized business and thought leaders and by doing research on firms to discover those with the highest price-earnings ratios over 10-year spans. These data are not collected with academic rigor but are still useful in highlighting the authors' points about the most successful US firms.

Reading this book is somewhat difficult. At times it reads like a management seminar or coaching session put into print. Diagrams, lists, 2x2 matrices, and self-diagnosis questionnaires are liberally sprinkled throughout each chapter. These learning tools are largely helpful. They stopped my reading flow and made me think. I finally decided that this book is meant to be used by a consultant working with a board preparing for a leader assessment or succession planning. It could also be used as part of a personal development process for a current leader. The questions the book poses are excellent. This book is a must read and will repay diligent readers with valuable modern insights on leadership as an internally and externally grounded construct.

CEO of Me: Creating a Life that Works in the Flexible Job Age

Authors: Ellen Ernst Kossek & Brenda A. Lautsch
Publisher: Wharton School Publishing, 2008

Reviewer: Jesse S. Michel, Department of Psychology, Florida International University

As leading authors on flexibility and work-life issues, Ellen Ernst Kossek and Brenda Lautsch are ideal representatives for a book bridging rigorous academic research with popular press application. Deriving from the authors' numerous research studies, this book offers practical options to manage work and family relationships to create a better working life. The authors suggest their book will allow readers to determine, assess, and improve their work-life to be happier, healthier, and more efficient, thus becoming more self-actualized "CEOs" of their own lives. This book is also helpful for managers who can use these concepts to better assist their associates in work-life issues and shift their organization's culture.

The content follows three general themes. The first two chapters revolve around individual values and behavioral trends. Chapter 1 asks the question: Are you the CEO of your working life? The authors then propose the term *flexstyle* as a novel way to approach how individuals manage work and life.

Chapter 2 illustrates three quasi-nomothetic flexstyles: *integrators*, *separators*, and *volleyers*. These flexstyles represent the extent to which one blends work and personal life in both physical (time, schedules, space) and psychological (thoughts, emotions, energy) aspects, where integrators are high at blending, separators are low, and volleyers switch back and forth between the integrator and separator flexstyles.

The next four chapters deal with the second theme: the tradeoffs associated with flexstyle. Every style has its tradeoffs, and one needs to recognize them and reflect on one's values to determine which tradeoffs are major and minor. The authors stress the importance of consciously choosing which flexstyle most aligns with one's values, while recognizing that some flexstyles are not sustainable over time or good for one's physical or psychological health. Some of the best aspects of these tradeoff chapters include numerous case studies and quotes, explicit pros and cons for flexstyle subgroups, and self-assessment tools for each flexstyle subgroup.

Chapters 7 through 10 address ways to improve and maintain your flexstyle. These include changes everyone can make to gain control and improve the quality of their life.

This book is for anyone wanting practical options in managing work and personal life relationships positively and productively. Its extensive illustrations, tips and suggestions, and diagnostic tools help determine one's flexstyle, the discrepancy between actual and ideal approaches to work and life relationships, and how to modify these behavioral trends to align with one's work-life value system. Furthermore, managers can use these concepts to assist their associates in work-life issues and make their organizations more work-life friendly.

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Appropriate subject areas addressed in the journal include, but are not limited to, five focused knowledge areas: **HR strategy and planning, leadership development, talent management, organizational effectiveness, and building a strategic HR function.** Articles integrating knowledge across the domains are particularly encouraged.

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- Book reviews
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Send submissions by email to:

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