pay for performance: the CFO's stake

BlueCross BlueShield of Louisiana developed an innovative way to align corporate goals, strategies, and employee accountability.

By Mark Rishell and Walt Becker

CFOs are increasingly concerned about their company's ability to achieve desired results as fierce competition, savvy consumers, uncertain economic and regulatory environments, and innovation are the norm. To win, and in some cases simply to survive, companies must help employees commit to the overall corporate strategy, understand how their performance contributes to results, and be motivated to make a difference.

CFOs view aligning operational goals with desired financial objectives as a natural outgrowth of their responsibilities that can make or break the bottom line. Many also recognize the need for an integrated, systemic approach to performance that drives organizational alignment, capability, and accountability. BlueCross BlueShield of Louisiana (BCBSLA) implemented a Performance Accountability System (PAS) to achieve this. Developing and implementing such a business process requires the leadership, financial, operational, and organization change expertise that only senior executives can provide.

When I (author Mark Rishell) joined BCBSLA as CFO in 2002, the company was generating, and continues to generate, excellent financial results. Nevertheless, BCBSLA still needed to change. Our recent results were driven largely by an industry-wide positive underwriting cycle, profitable contractual relationships with other Blue Cross Blue Shield plans, and the company's continued presence as the market-share leader in Louisiana. Like other health insurers, BCBSLA faces continuing increases in healthcare costs and competition. Our company's long-term competitiveness depends on our ability to manage our risk pool, operate more efficiently, and develop innovative products. To fulfill our mission of providing excellent service and access to high-quality and cost-effective healthcare, we needed to improve our ability to acquire and retain a targeted pool of customers, reduce operating costs, and develop products that meet the needs of our markets. To achieve our objectives, we found ourselves exploring significant potential investments in technology and process redesign. As we evaluated technology upgrades and processes to redesign, it became clear that our success in transforming the organization was dependent on our employees and their ability to manage in a changing culture. To support these planning efforts and the objective of ensuring continued long-term success, our board of directors engaged Sibson Consulting to review the company's executive pay and performance practices. Their objective was to make recommended changes to the way BCBSLA manages executive pay and performance in order to:

1. Align the system with BCBSLA's strategic directions and drive desired business results.
2. Ensure that BCBSLA's programs are industry standard in design, that they are competitive in financial rewards, and that costs are consistent with performance.
3. Sustain BCBSLA's ability to attract, retain, and motivate its executives.

The result of Sibson's early efforts with our company was a Performance and Rewards Strategy that clearly defined a "performance contract" between the board and management. The strategy addressed six principles to guide the development and management of executive pay and performance programs:

◆ **Pay Prominence**, defined as the extent to which compensation should influence employee actions and decisions.

◆ **Competitive Framework and Positioning**, defined as criteria for choosing companies used for pay and performance comparisons, competitive positioning of target pay levels relative to the defined peer group, and the mix of compensation elements including salary and performance incentives.

◆ **Performance Measurement and Goal Setting**, defined as the type of performance measures (e.g., financial, operational, measurable), the organizational level(s) at which results will be measured, the degree of judgment employed in making incentive award decisions, the time frame of measurement for incentives, the standards against which performance will be measured for incentives (e.g., historical performance, peer group performance, budget), and the types of measures, goal attainment expectations, and repercussions/rewards associated with performance.

◆ **Career Development**, defined as the importance and opportunity for career growth within the company.

◆ **Governance**, outlining decision-making roles of the board, Compensation Committee, and senior management for the design and management of compensation programs.

◆ **Communication Guidelines** for communicating compensation programs, corporate strategy and goals, individual performance expectations, and performance assessments and resulting rewards to employees.

Two significant implications of our Performance and Rewards Strategy were that BCBSLA needed to increase focus on desired results and drive greater organizational and individual accountability. The strategy initiated an evolution to a performance-driven culture that would drive achievement of our strategic objectives. Specifically, it called for:

◆ Clearer expectations for individual contribution,
◆ Greater accountability for performance against expectations, and
◆ Greater differentiation in performance assessments and rewards.

BCBLA's CEO at the time, Kathryn M. Sullivan, defined a clear mandate for change. "Everyone in our organization must fully understand the corporate direction and have the understanding, knowledge and skills, and commitment necessary to contribute to company results," she said. "A performance accountability system will help us move to a high-performance culture."

Management reengaged Sibson Consulting to help BCBSLA implement the principles defined in the Performance and Rewards Strategy. Ultimately, these principles would drive the company's transformation by aligning operational goals and individual performance expectations with strategic and financial objectives, motivating employees with performance-based rewards and consequences, and managing and developing talent using a more rigorous performance management process. This process became known within our organization as the Performance Accountability System. The systemic nature of the PAS is compelling. It isn't merely a collection of finance and HR programs du jour—it's a logically integrated approach that lets managers and employees work better together to achieve desired results.

The remainder of this article provides you with my perspective as CFO and Walt Becker's perspective as lead consultant. We'll discuss my role in developing PAS and why I felt it should be a priority, what PAS is, how it works, and what we expect it to deliver.

THE CFO'S ROLE AND STAKE IN PAS

What's at stake, and why did I—why should any CFO—take a lead role? First, the Sarbanes-Oxley Act has raised the already high bar on the CFO's fiduciary role. In addition to being strategic business partners in helping our CEOs direct the business, CFOs now must reemerge as effective controllers of financial planning, accounting, and budgeting. We must understand the operational drivers of the business, influence goal setting, and ensure that our organizations can realistically achieve desired results.

Second, people costs are the largest operating expense in many companies. As we seek to improve results, increasing the return on this significant investment is an important focus. Because most of us CFOs consider return on investment (ROI) within the scope of our accountability, we have a vested interest in championing changes to pay-for-performance programs and operational goal setting.

Finally, a strong CFO positions finance as a strategic partner to line management by challenging the status quo and teaming up with management to make changes that contribute to improved business results. These changes include strengthening the connection between financial and strategic planning, improving the return on operational investments by developing strong business cases, and improving the alignment of operational and organizational goals with strategic financial objectives.

Impacting Business Results

At BCBSLA, I was the newest member of the management team, so aligning performance management practices with strategic and financial corporate goals provided a unique opportunity for me to make a lasting impact on business results by:

- Integrating corporate planning and budgeting processes with operational goal setting,
- Establishing cross-functional accountability and management ownership over key business drivers,
- Aligning performance objectives from top to bottom,
- Improving the company's ability to set and achieve aggressive goals, and
- Increasing the return on people costs.

Assisted by Walt and his team, I led an initial effort to translate our strategy into financial and operational requirements using value tree models to evaluate and demonstrate the drivers of the business. I led discussions with the rest of the senior management team to validate these drivers. "This helped to depict what drives success in a way that we hadn't seen before," VP of Human Resources Sandra Smith said. "The influence of the CFO and his fresh insight as a newcomer to our organization were invaluable in helping to make the connection between business needs and the design requirements of the PAS. He kept us focused on business results and how we spend our money on people."

The process strengthened management's collective understanding of how the company makes money and which lines of business contribute to top- and bottom-line success. It also yielded a framework that defined the links among organizational, operational, and financial results. Management is committed to PAS because it tightens the connection between organizational performance objectives and desired financial results, and it isn't just a collection of finance and HR programs with little potential impact.

A Good Partnership

Our success can be partially attributed to a partnership between Finance and HR, which was enabled by:

- My being "at the table" with the VP of HR as part of the senior management team,
- My comfort in wearing an "HR hat,"
- HR's comfort working with the CFO,
- The VP of HR's ability to wear a "business strategy hat,"
- Respect for each other's roles and expertise, and
- The consultant not being individually beholden to me or the VP of HR.

What role should you play in your company? Ask yourself these questions:

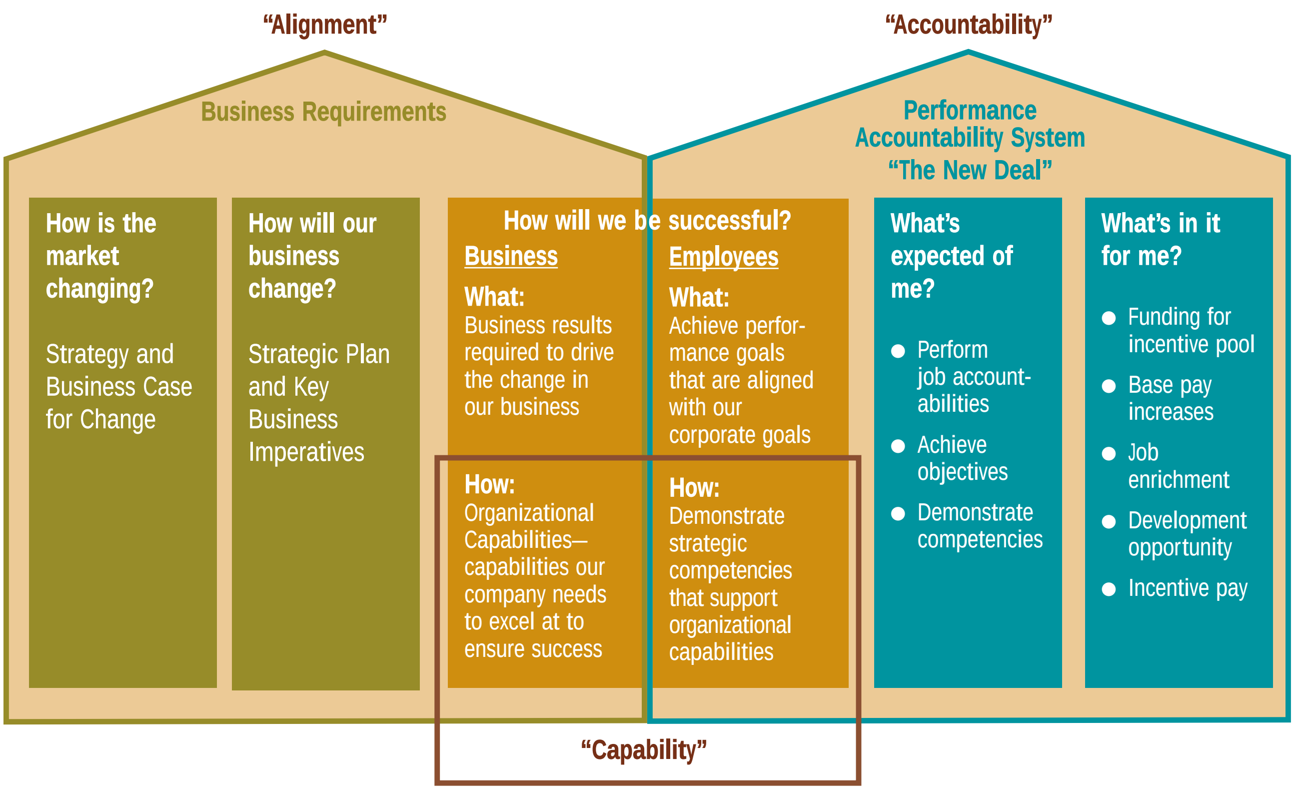
1. Am I satisfied with my company's level and type of financial and operational results?
2. Are our operational results consistent with our company's financial performance?
3. Does the management team share accountability for performance on critical operational drivers, and can they align the efforts of their staff with necessary business results?
4. Do our employees understand how they contribute to business success?
5. Are our employees committed to making a difference?

WHAT IS THE PAS?

Our Performance Accountability System is a tightly integrated set of practices and tools designed to improve business results and support BCBSLA's transformation to a high-performance organization and culture. It consists of three elements:

1. A new approach to compensation, with a significant individual incentive opportunity for top performers and broader salary ranges with midpoints benchmarked to the competitive market median.
2. A rigorous approach to performance management, with clear corporate priorities and high individual

Figure 1: BCBSLA's Performance Accountability System



performance expectations and standards aligned with those priorities.

3. Strong and clearly defined linkages among performance management, compensation, and consequences.

In partnership with our consultants, we developed a framework to guide the development of our Performance Accountability System that focused on answering five critical questions that define how the PAS impacts the company and each individual employee. See Figure 1.

1. How is the market changing?

Market dynamics are an important factor in clarifying strategy and building the business case for change. This is particularly important if the company is a strong performer and has no obvious internal need to change.

At BCBSLA, our senior management team understood that increasing industry competition and consolidation among BlueCross BlueShield plans meant that, to remain independent, we would need to maintain our leading market share and become more operationally efficient and flexible to compete on a cost and service basis. One of the major challenges we face today is the rising costs of healthcare driven by factors including costs of prescription drugs, an aging population, cost shifting resulting from underfunded government programs, and legal costs stemming from exorbitant damages awarded in malpractice suits.

Competitors in our industry are using three strategies to improve their competitiveness in the face of rising costs:

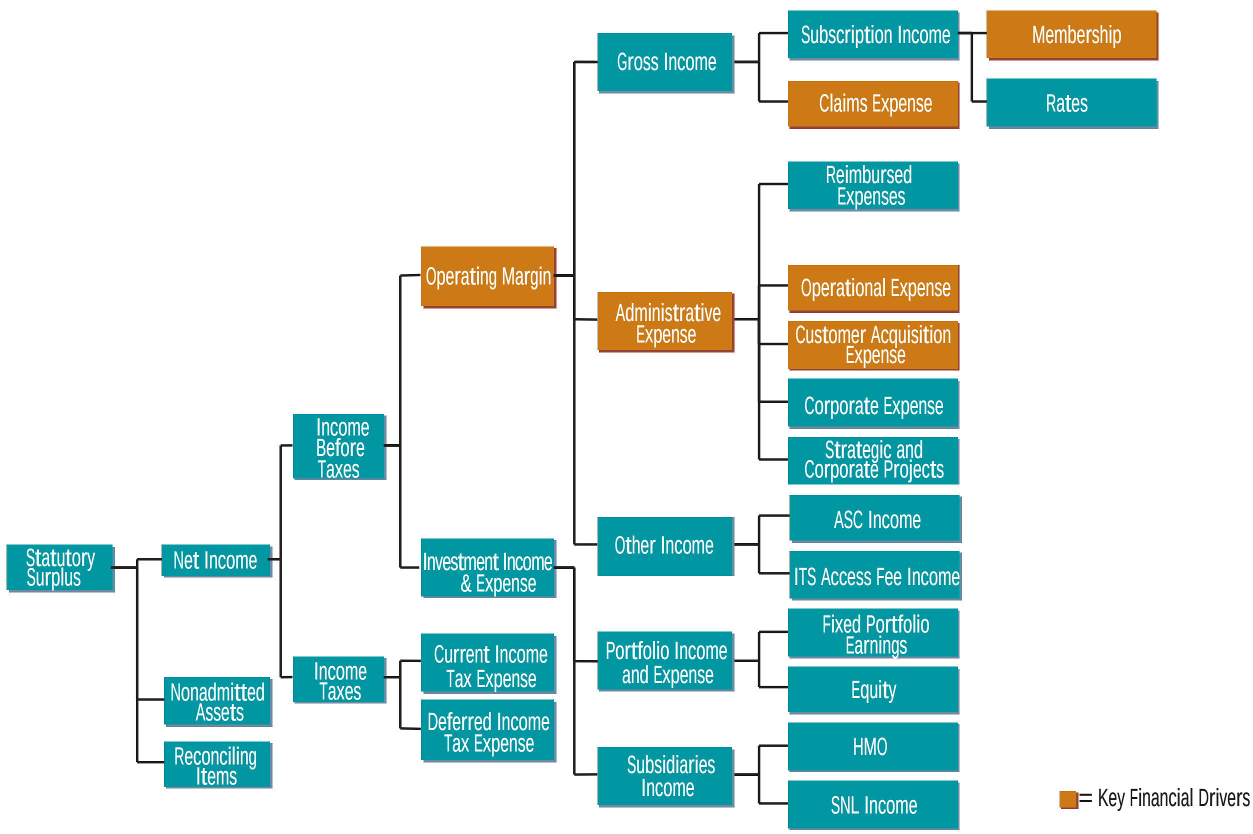
- Geographic expansion to gain economies of scale and access to a greater pool of potential customers.
- Expense reduction and productivity improvement to enable competitive pricing.
- Product innovation to attract desired customers and compete on value rather than price.

We can't sit still! Given our strategic intent to remain an independent, single-state Blue plan, we must aggressively manage our costs, maximize our productivity, and target customers with products and services that bring value.

2. How will our business change?

Companies must identify the key business drivers and the performance changes that are necessary for success. We examined the drivers of our recent financial success and found that operating results from those activities the company performs on a daily basis are a relatively small contributor to our performance. But a combination of market factors, including the impact of a positive under-

Figure 2: BCBSLA's Enterprise Value Tree



writing cycle on premium rates and fees received from national accounts, were significant drivers of operating and net income. We concluded that if we were aggressively managing costs, maximizing productivity, and attracting and retaining members with valuable products, our operating results would be a greater driver of our overall financial success. A part of the solution: Set better, more aggressive goals, and drive greater organizational and individual accountability for success.

3. How will we be successful?

We identified two areas that define success: business results and the development of critical enterprise capabilities. With guidance from Walt and input from senior management, our project team (composed of both BCBSLA staff and senior-level consultants) developed schematic pictures, called value trees, of the drivers of our business. Although we developed value trees for the entire enterprise, including all major functional areas, the value tree in Figure 2 illustrates the concept.

We used the value trees to identify operating goals that aligned directly with our corporate strategic objectives. These enterprise operating goals formed the foundation for identifying and setting goals for our operating units and functional areas. In the first year, our operating goals aligned with corporate objectives were:

Corporate Objectives	Operating Goals
Financial Stability	Statutory Surplus
Profitable Growth	Customer Acquisition Expense
Resource Management	Administrative Expense
Quality Performance	Member Retention

In addition to defining desired financial and operational results, our project team identified the core capabilities we needed as an organization to achieve our goals. These are capabilities of the company that we aim to strengthen to improve the economic and market value generated by BCBSLA. Due to the strategic and competitive nature of these capabilities, we can't share them in detail, but we can tell you that they focused on building and institutionalizing greater market acumen, increasing our focus on customers, and reinforcing our leadership in our markets.

4. What's expected of me?

This is where "the rubber hits the road." Strategic and enterprise performance planning can't be executed successfully if we can't tell employees what we expect of them and how these expectations fit with our corporate objectives. Differentiation in performance can't be judged without greater clarity in performance expectations. We defined three categories of performance that we expect from all of our employees:

1. Job Accountabilities—what we pay our people a salary for doing on a daily basis. These accountabilities relate directly to the business results or outcomes expected of the role.

2. Performance Results—extraordinary or strategic results the company is willing to pay more for. These are the results that form the basis for developing goals for incentive purposes.

3. Competencies—the behaviors and skills we expect our employees to demonstrate and develop in their respective roles. We defined two types of competencies. Strategic competencies are related directly to the organizational capabilities the company identified as areas of competitive differentiation. Job-specific competencies are rooted in the skills and knowledge required to perform the role.

The integrated and systematic nature of the Performance Accountability System enabled us to develop performance expectations in each of these categories that are clearly connected to the company's business objectives.

5. What's in it for me?

The final element of the PAS is the rewards and consequences of performance. To be able to drive better business results through clearer performance expectations, we needed a new approach to compensation. An examination of our current pay and performance practices revealed three that weren't consistent with the objective of driving greater accountability for results. First, performance bonuses for all employees were based primarily on the company's performance against financial results. This practice created quite a disconnect between what our employees, including our leadership team, could directly influence in their roles and for what we were paying them incentives. Second, our highest-rated employees weren't awarded significantly more in bonuses than others. Since we wanted to drive greater accountability for more specific results, we increased the variability of bonuses based on performance. Third, we found that our organization wasn't good at creating differentiation through objective performance evaluations. Nearly 70% of our employees were consistently rated in our top two, out of five, performance categories. To make the Performance Accountability System a success, we needed to provide our managers with the skills and tools necessary to be more rigorous and objective in managing and assessing performance.

HOW PAS WORKS

The annual PAS process has two primary components: goal setting and performance management and rewards. Figure 3 is a high-level depiction of the process.

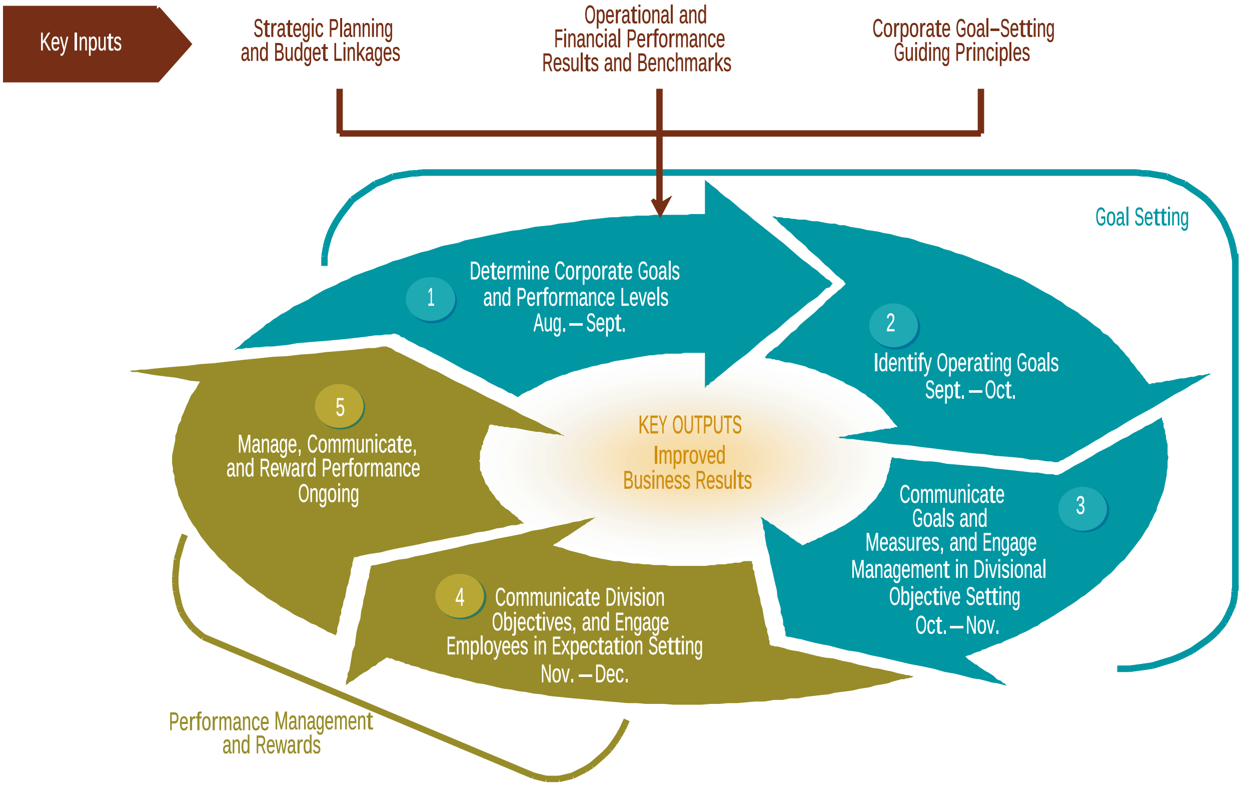
Step 1: Determine Corporate Goals and Performance Levels

Our finance function synthesizes and summarizes three to five years of financial, operational, and market data for distribution to our management team. We establish a set of recommended goals, including the business case and proposed performance levels for each. Finance then develops three performance levels (threshold, target, and superior) for each goal and discusses them with the management team. Ultimately, our senior management team finalizes the goals, business case, and performance levels for presentation to our board of directors.

Here are some questions we ask when reviewing our performance data, determining goals, and setting performance levels:

- Given our strategic direction, do these goals best reflect the most important bottom-line results for the company?
- To what degree is each of the goals aligned with our strategy? In what way can we better align them?
- What financial and operational results/marketplace factors/industry trends support the recommendation of these specific corporate goals?
- What's the potential impact that achieving this goal will have on the organization? Can this impact be classified in quantitative or financial terms? Does achieving these goals deliver an adequate return on investment?
- Where do we agree about impact and improvement opportunities? Where do we disagree about impact and improvement opportunities? Why do we disagree on these points?
- What performance levels are appropriate considering our business situation? What performance levels are defined or implied by corporate budgets? What performance levels are appropriate to ensure executive rewards competitively compensate for relative performance?
- Is the right degree of "stretch" built into each of the performance levels? (Consider historical performance levels, recent performance trends, expected business conditions in the coming year, etc.)

Figure 3: BCBSLA's PAS Process



- Is the difference between performance levels (and the associated rewards with each level) significant enough to motivate someone to achieve higher levels?
- Do current systems provide sufficient information to track performance on these goals?

Step 2: Identify Operating Goals

The purpose of this step is to identify and create a shared understanding of operating priorities and performance goals that align with and drive results against annual corporate goals. We determine shared accountability for management and identify cross-functional teams that will drive and monitor performance regarding the operating goals. Our VP of Human Resources and I lead a process to engage management in operational goal setting. Our management team then develops recommendations, with supporting business cases, that senior management must approve.

These questions are helpful when establishing operating goals:

- What operating results have the greatest impact on our ability to improve performance against our strategic goals year after year?
- Given our historical performance and benchmark data, as well as our strategic plan and associated initiatives, what operating results are most important to focus on to achieve the current business objectives? Where are the biggest opportunities to improve performance?
- Are there any additional divisional/departmental operating results or strategic initiatives that might be important to focus on as an organization and share with others?
- Which of the operating goals does your division/department impact most directly? How?

Step 3: Communicate Goals and Measures, and Engage Management in Setting Division Objectives

In this step we develop division and department objectives that align with corporate and operating goals. We determine shared accountability for directors and managers and develop concrete implementation plans. In division- and department-level meetings, our management team shares with directors and managers the corporate goals, corporate strategic initiatives, and operating goals, explaining how they are aligned and highlighting the goals for which the division/department has shared accountability. Then it leads directors and managers in

Table 1: Expectations of Managers and Employees

WHAT MANAGERS NEED TO DO	WHAT EMPLOYEES NEED TO DO	WHAT BOTH NEED TO DO
◆ Set and communicate operating goals and department objectives that are consistent with corporate goals.	◆ Be proactive about developing performance expectations that are aligned with department objectives and operating goals. Clarify expectations as needed.	◆ Identify and discuss when expectations may need to change.
◆ Clearly communicate individual expectations.	◆ Monitor own performance, seek performance information, and inform manager of successes, shortcomings, and needs.	◆ Identify and discuss resources required to achieve goals and expectations.
◆ Provide clear feedback on an ongoing basis. Check for understanding of the feedback.	◆ Ask questions to understand feedback, and act on it.	◆ Practice giving and receiving feedback.
◆ Hold employees accountable for their actions. Recognize own responsibility to help employees improve.	◆ Take accountability for performance. Actively look for ways to improve it.	◆ Identify people and resources inside and outside the company that can help improve employee performance.
◆ Review performance fairly. Share reviews with employees before they are final.	◆ Engage in self-assessment, and actively participate in performance reviews.	◆ Recognize development as an investment. Track progress against development plans.
◆ Offer suggestions for development actions. Deliver on agreed-upon development opportunities.	◆ Create personal development plan.	
◆ Differentiate rewards according to employee performance.		

discussions about what the division/department can do to impact the performance of the shared goals. Next, teams of directors and managers are formed to developed recommended performance levels and create implementation plans.

These questions are helpful when establishing division/department goals:

- What are the three to five most critical division/department goals, and what is the supporting business case?
- What can we do to influence the goals for which our division/department has shared accountability?
- Where do we have the greatest opportunity to improve division/department performance?
- Are there any division/department initiatives for which we should set objectives?
- What specifically do we need to do in order to achieve our performance targets? What additional actions would be required to achieve superior performance levels?
- Who is accountable for each action?

Step 4: Communicate Division Objectives, and Engage Employees in Setting Expectations

Step 4 is designed to tell employees the key business objectives and goals and discuss expectations for the year ahead. Critical outcomes of this step include a shared understanding of corporate financial and operational goals, division/department objectives, individual expectations, and consequences of individual performance.

In department/team meetings, directors share the corporate goals, corporate strategic initiatives, operating goals, and department objectives with their direct reports. The director explains how all are aligned, describes the process by which department objectives were set, and highlights the shared and team accountabilities needed to achieve department objectives.

Next, the director leads his/her direct reports in discussions to determine what they can do to help the department achieve its objectives. The discussion of individual expectations for the coming year centers around the three performance dimensions: performance goals (often department objectives), job accountabilities, and competencies. After discussing the performance dimensions, the director:

1. Establishes with his/her direct reports the desired individual results for the year. The performance discussion includes a focus on the specific competencies that can help achieve the performance goals and considers the impact on job accountabilities.
2. Outlines the performance-level definitions to ensure that all direct reports understand the meaning of

"meets expectations" and how employees might demonstrate each performance level for each job accountability and competency.

3. Identifies and discusses resources required by the employee to achieve individual expectations.
4. Determines the criteria for identifying if and when individual expectations may need to change during the year.

Key questions we address throughout this process step include:

- To what degree do you/can you personally impact or contribute to the achievement of our department objectives or corporate goals?
- In what ways do you/can you impact department objectives?
- What barriers to achieving our department objectives does our team face? If we were able to remove these barriers, do you think the team and/or you as an individual would be better able to impact our department objectives?
- What resources or information do you need to meet your expectations? Specifically, what do you need, from whom do you need it, and how will you work with them to get it?
- How should we measure success in achieving accountability? Specifically, what will it look like, what are the metrics, and what is a reasonable range of expectations on performance?
- What competencies do you think you should focus on to help achieve our department objectives and your job accountabilities for the coming year?
- Are individual expectations clear and attainable?
- What are the potential consequences of achieving or exceeding individual performance expectations? Failing to meet expectations?

Step 5: Manage, Communicate, and Reward Performance

This step is an ongoing process. Our objective is to engage all employees and managers at every level of the organization in an ongoing performance discussion throughout the year to strengthen everyone's understanding of corporate, department, and individual performance. We regularly review corporate and individual performance based on observable indicators to identify goals that require additional attention, and we formally assess corporate, department, and individual performance at the end of the year and determine rewards based on demonstrated performance.

This process works only when the discussion about expectations and performance is "owned" by both the manager and the employee. Table 1 shows our expectations of managers and employees.

As you can see, the Performance Accountability System is an integrated, systematic approach to managing individual performance and enterprise performance. It has become one of our most important business processes.

THE RESULTS

This effort at BCBSLA is driving improved business results and initiating visible employee behavior changes. The focus on operating results is also making a difference. For example, the company reduced the growth in new-member recruitment costs and per-member administration costs.

We have formed cross-functional management teams to monitor and influence ongoing performance on critical operational drivers. There are more conversations about performance variances and drivers rather than reported financial results. And there is growing interest among managers and employees in the company's evolving approach to performance accountability.

Our ability to align goals, set individual performance expectations, assess results, and develop employees has improved and will continue to do so as the company's culture continues to evolve. The investment in PAS has led to greater organizational alignment, a focus on developing critical capabilities, and significantly improved differentiation in performance assessments and rewards. In the first year, for example, our distribution of performance ratings shifted from 70% of our people in the top two categories to approximately 40%. Ultimately, our ability to set more aggressive goals and hold ourselves accountable for results will enable us to lead changes in our market as we pursue our mission of improving the value BCBSLA delivers to the people whose health it insures. ■

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