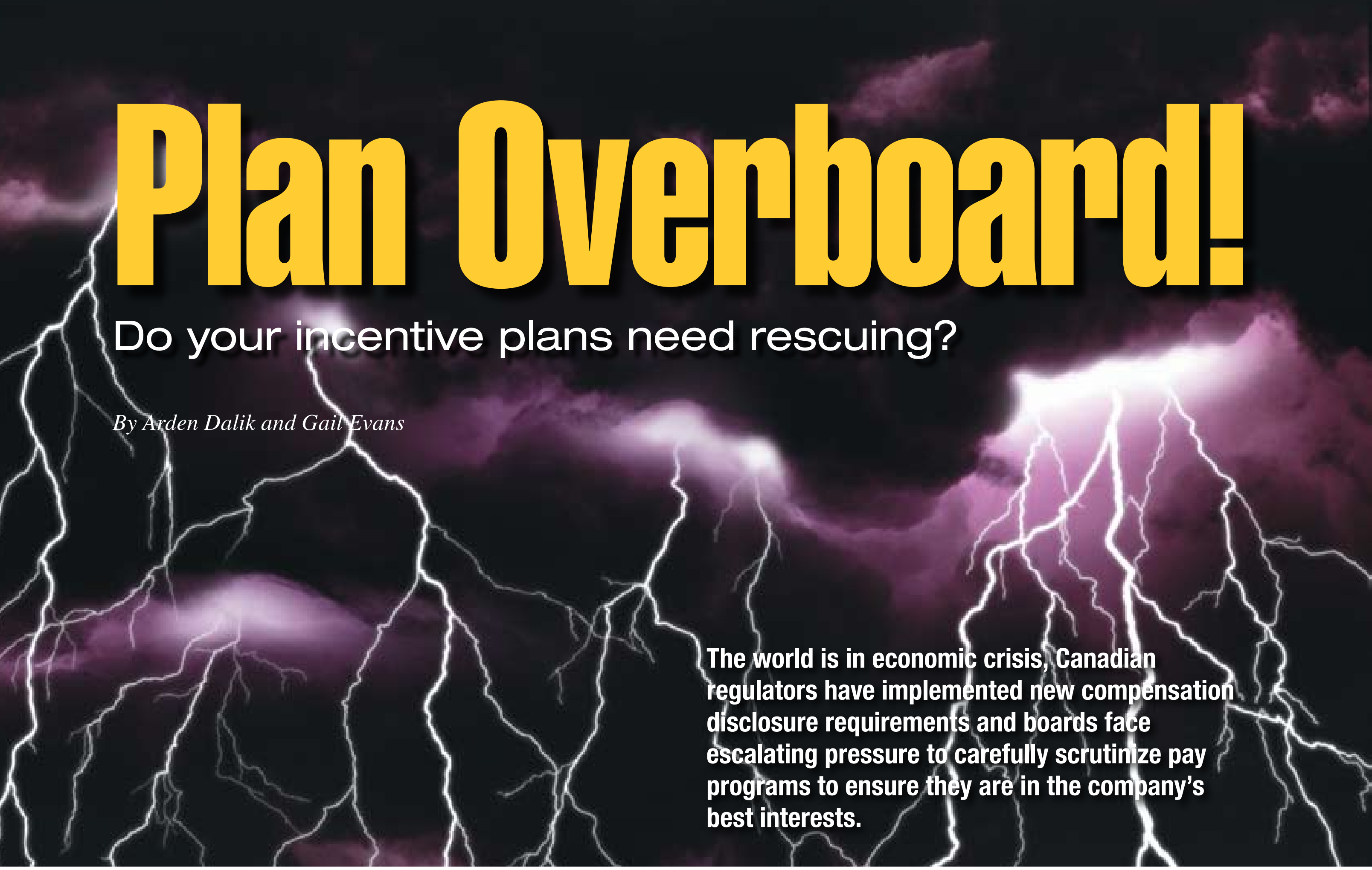


Plan Overboard!

Do your incentive plans need rescuing?

By Arden Dalik and Gail Evans

The world is in economic crisis, Canadian regulators have implemented new compensation disclosure requirements and boards face escalating pressure to carefully scrutinize pay programs to ensure they are in the company's best interests.

Will your incentive plans withstand the pressure of new disclosure rules, board review and shareholder scrutiny in this economic tsunami?

If it's any consolation, you're not alone.

A flotilla of company plans are desperately in need of rescue and in some cases resuscitation. Here, we explore the common challenges incentive plans are facing and how to revive them. Also, we look at a number of steps to get them back afloat.

Before the storm

Until a few years ago, there was a tremendous focus on the long-term incentive (LTIP) element of total compensation plans (e.g. stock options). Because of this, many organizations focused compensation design efforts on LTIP competitiveness. In recent years, LTIP's began to fall out of favour for a variety of reasons, including a requirement to disclose LTIP value in financial disclosure documents. As a result, we've seen an increase in focus on short-term plans. In addition, a wide-variety of "creative alternatives" have been created, including mid-term cash plans, stock appreciation rights, phantom plans, etc.

The Wave Changes Direction… Again

The world is in economic crisis, Canadian regulators have implemented new compensation disclosure requirements and boards face escalating pressure to carefully scrutinize pay programs to ensure they are in the company's best interests.

At the same time, the wave of uncertainty is continuing to build. This requires critical reexamination of business strategies and operations in both the short and long term. Under new disclosure requirements for Named Executive Officers (NEOs), it will no longer suffice to report the dollar value of cash bonuses, for example. Now a separate Compensation Discussion and Analysis (CD&A) must be prepared, including descriptions of the incentive plan's measures and the illustration of the link between pay and performance. This will likely signal the end of the "discretionary bonus." In addition, shareholders are beginning to want a "say in pay" – a movement that was started in the U.S.

Complicating this new scrutiny is the fact many companies charted the course for their incentives two or three years ago, before the current storm washed out assumptions of ongoing financial growth. As strategies and plans are being revisited, this will naturally signal a need to review incentive plans. Leaving your incentive plans drifting can have some serious negative effects. It can work against your current initiatives by continuing to focus and reward outdated behaviours and results. For example, if your incentive plan rewards market share but the revised strategy focuses on operational efficiency, you could send employees sailing in the wrong direction.

Identify Storm Warnings

While many types and designs of incentive plans exist, the symptoms of an ineffective one are generally very similar.

The signs that your plans are performing sub-optimally include:

- Tremendous "push-back" and surprise from employees upon distribution
- Challenges from the board or other key stakeholders
- Formulas that result in proposed payouts the company cannot afford
- "Windfall" payouts and/or "no payout" situations, resulting from environmental factors employees could not impact
- Treating the plan like it is part of base pay – entitlement
- Failure of employees to shift efforts to align with new business strategy
- Inordinate focus on a few business metrics
- Plan design not reflecting the reality of the environment – economic slowdown, competitor changes, shareholder concerns, disclosure optics

Diagnose Problem Severity

Seven key design features determine in large part the potential effectiveness of the incentive plan.

They are:

1. Alignment with revised business strategy and current business environment
2. Economics of the plan
3. Performance metrics
4. Formula/Scorecard
5. Participation
6. Stakeholder buy-in
7. Ongoing monitoring and communication

As you complete a diagnosis of your plan's effectiveness, here's what you should consider in each key design areas:

Alignment with revised business strategy and current business environment

When you analyze all the pieces of the plan, including how it is actually distributed, they should be incenting performance consistent with new business direction and the economic realities of the organization – ability to pay.

Competitors are re-evaluating their programs, directors will be asking more questions and YOU will likely be asked to provide input into rationale for the performance metrics, formulae and payout levels. You will need up-to-date market data, a sense for trends in shareholder concerns and, even if you're not a public company, familiarity with new disclosure requirements, as they're going to put pressure on almost all corporate incentive plans.

Is there a need to shift focus to long term from short term because of the current financial challenges that many organizations are suffering?

Economics of the plan

Has the plan's funding been carefully calibrated?

Many incentive plan designers without a solid grounding in finance neglect to do proper analysis to ensure design can stand up to rigorous financial tests, such as self-funding.

While often incentive plans are not self-funding out of the gate, all should aim to be after a certain of time – usually 2-3 years.

Do plan provisions allow for claw-backs when a financial restatement shows the target performance was not actually attained?

Performance metrics

There are many considerations when it comes to selecting performance measures for your plan. Have the following been considered in the design of your program?

a) Looking down the horizon to solid landmarks is a way to focus efforts on meaningful goals. With current economic turbulence creating muddy water, longer-term goals are often clearer and a means of moving forward to ensure structure is in place for future success.

b) The use of a "balanced" group of performance measures – Regardless whether a company uses a balanced scorecard or a more formula-based approach, it is critical the incentive plan incorporate a variety of measures. Measures which encourage short-term profit (increased revenue) need to be balanced with those that ensure future value is simultaneously created (increased number of clients or market, research and development, inventory control, etc.). And collectively, they should support the business strategy.

c) Cascaded performance measures – Ensure corporate goals are aligned to business unit goals, which are then linked to team goals and are finally linked to individual goals. This way, employees at all levels will be able to see how their job and their performance help to drive business strategy.

d) 'Line of sight' – Employees should have some impact on the performance measures used in the incentive plan. Obviously external factors (commodity prices, weather, wars, etc.) may have impact no one in the organization could either control or take credit for. But employees should be able to understand they can affect goals with their performance and/or mitigate the effects of uncontrollable external factors.

Formulae/Scorecards

How complex are your current incentive formulae?

The general rule of thumb is to keep plan design as simple as possible. Typically, everyone involved in the initial design process starts with an objective to keep it simple. However, as the design process unfolds and details about business strategy and objectives come to light, a desire to capture everything emerges.

Using the balanced scorecard methodology as foundation for incentive plan design can facilitate this process. The strategy map, or story, makes linkages between performance measures much more clear to employees. Thus, the need to limit measures to four or five is reduced. Then, the incentive plan isn't merely a compilation of measures, but rather another powerful vehicle for communicating business strategy.

Participation

Plan participation is an important consideration. Companies have been pushing incentive plans participation further and further down into the organization. You will need to examine the marketplace practices as well as the organizational culture to determine whether your participation or eligibility is appropriate.

The degree of risk employees can tolerate or desire is an important consideration when determining organizational levels to include in the plan.

Stakeholder buy-in

Have your key stakeholders (executives, directors, shareholders) really bought in to the incentive plan measures and objectives?

Often incentive plans end up being driven by – or blamed on, when they are not working – the human resources department. To utilize the incentive plan as a strategic business tool, it must be universally seen as owned and valued by the key stakeholders of the organization. Best-practice organizations ensure top management is not only on board, but are the key drivers of incentive plans. In this new environment, directors and even shareholders will take on larger roles in the oversight of these programs and their alignment with the business direction. Proactive communication with key stakeholders will enhance the success of any incentive plan changes.

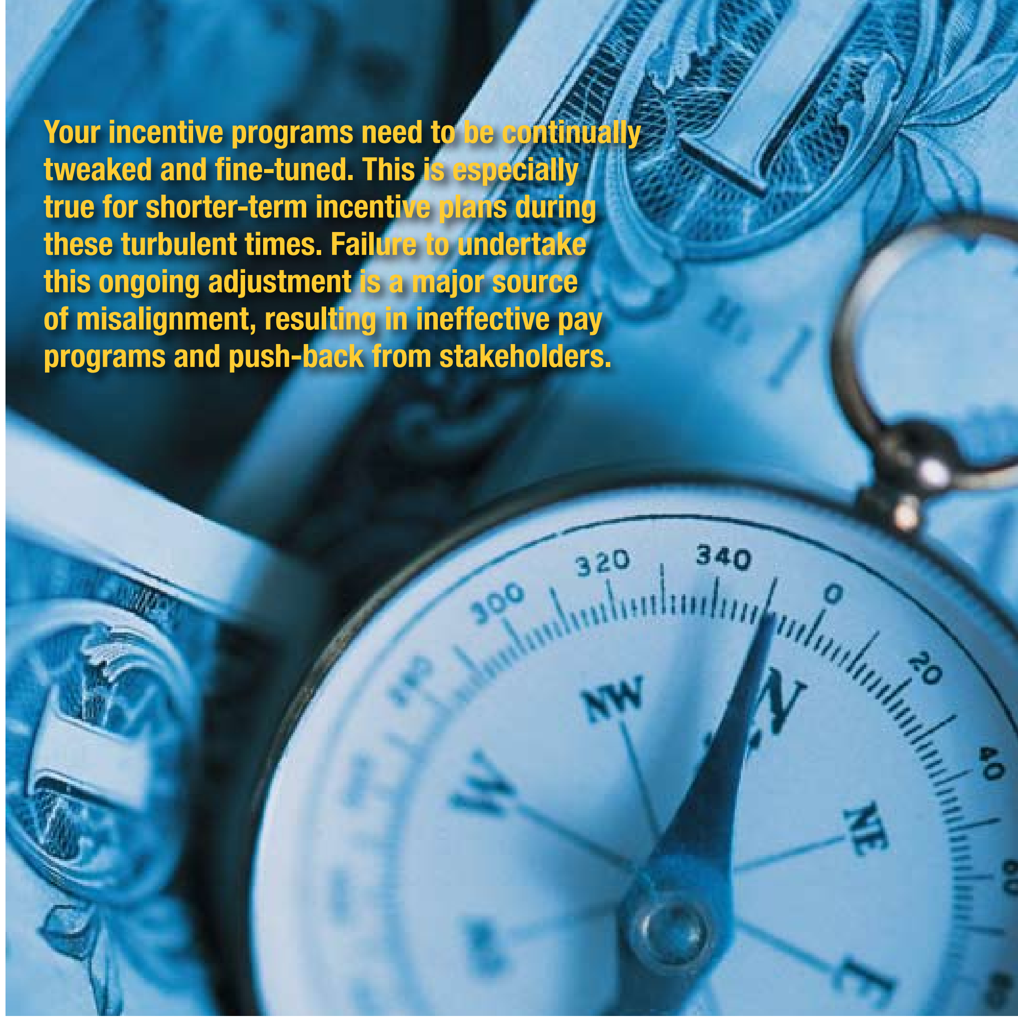
Ongoing monitoring and communication

Employees are definitely feeling adrift in this uncertain environment. The review and realignment of performance metrics, for example, is a prime opportunity to communicate and reinforce new business focus and priorities. Literally putting your money where your mouth is signals to employees a new direction, for example, and these measures are illustrative of that new business plan. All stakeholders, as appropriate, should receive communication before, during and after any incentive plan changes.

There will be new challenges will the already difficult task of setting accurate and realistic performance measures, especially in the short-term.

While it will be critical to align with the business strategy and performance measures, you will likely need to review your programs with best guess and/or influx information at present.

Finance and strategy people should have been engaged early in the process so they can provide up-to-date revisions



Your incentive programs need to be continually tweaked and fine-tuned. This is especially true for shorter-term incentive plans during these turbulent times. Failure to undertake this ongoing adjustment is a major source of misalignment, resulting in ineffective pay programs and push-back from stakeholders.

and/or trends in this turbulent environment.

Chart a New Course

Once you have completed diagnosis and identified incentive plan design features that require attention, it is time to put the rescue plan in place.

An effective design process encompasses four key features:

1. Use a review committee comprised of managers and employees where appropriate, and, of course, qualified consultants. This committee should:
   - Articulate how incentive plans are changing to provide alignment with new business strategy
   - Oversee and guide design and implementation
   - Review ongoing effectiveness of plan design

2. Involve employees in the process
   - Typically, one of the most important objectives in implementing an incentive plan is to drive or change employee behavior.
   - If employees are kept in the dark during the redesign process and suddenly receive a memo that a revised plan is being introduced, the likely reaction will be, at best, skepticism.
   - Conducting employee focus groups as part of the redesign process can accomplish a number of important objectives, including gathering insight on employee understanding of business strategy and objectives and gauging the likely impact of updated incentive plans on employee behaviour and performance.
3. Develop a navigation course for redesigning and implementing the plans
   - The map should identify the sequence of the design and implementation activities. There are a number of moving parts in any incentive plan design project, and a detailed project plan is critical to successful project completion.
   - Consider several scenarios in a portfolio of plans (short-, mid- and long-term), using a number of performance measures, including non-financial.
4. Avoid getting sent back to "walk the plank"
   - Check frequently with the group that will ultimately be responsible for approving the revised plan design. Too often, the design team proceeds on the assumption the executive team is on the same page, only to find out at the 11th hour that there is disagreement on something as fundamental as the plan's guiding principles.

Incentive Plan Navigation

To ensure that your incentive plan doesn't get lost at sea again anytime soon, it is important to consider the following factors:

1. Recognize the business strategy process is an ongoing cycle of formulation, implementation and evaluation

- Your incentive programs need to be continually tweaked and fine-tuned. This is especially true for shorter-term incentive plans during these turbulent times. Failure to undertake this ongoing adjustment is a major source of misalignment, resulting in ineffective pay programs and push-back from stakeholders.

2. Communicate. Communicate. Communicate.
   - The incentive plan sends clear messages about what is important to organizational success. It also motivates employees to engage in ongoing improvement activities and provides them with a stake in the business. It is truly an exceptional vehicle for communicating how the company is doing with respect to strategy execution and financial performance. This will be an invaluable asset in calming the crew and keeping them focused on the important task of running the business.
3. Provide frequent feedback and coaching to managers and supervisors on the effective use of the incentive plan as a pay-for-performance vehicle (in conjunction with effective performance management)
   - This is a great opportunity to provide managers and supervisors with coaching on giving and receiving feedback, how to set effective goals, etc.
4. Integrate the revised incentive programs into business operations
   - Continue to include incentive plan updates in leadership meetings and operational status reports
   - Proactively share business information and link it to revised incentive programs
5. Use a formal process for measuring and assessing program effectiveness

Post-Mortem

So now the cycle is complete. You have completed a diagnostic revealing the seaworthiness of your incentive plans. Even if your incentive plans appears ship shape, it will be important to continue to schedule alignment reviews to ensure it is still performing optimally.

Your incentive plans are almost guaranteed to come under scrutiny in the near future as a result of the current environment. Whether your plans need only a new paint job or a major overhaul, they should be addressed as soon as possible. Overlooking incentive plan issues will not only minimize the return on your compensation investment, but, more importantly, it can work against the attainment of your new business goals and invite attention from stakeholders – and not in a good way.

So batten down the hatches and begin to diagnose your incentive plans to ensure they operate as key strategic tools to help you to not only weather this economic storm, but also sail your company to success. ■

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