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Do Your Incentive Plans Need Rescuing?



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Will your Incentive Plans withstand the pressures of the new disclosure rules, Board reviews and shareholder scrutiny amidst this *economic tsunami*?

If it's any consolation your plans are not alone. There appears to be a flotilla of company incentive plans desperately in need of rescuing (and in some cases resuscitation). In this article we will explore some of the common challenges that incentive plans are now facing and how to revive them. We will look at a number of steps you can take 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 attention, many organizations focused their compensation design efforts on LTIP competitiveness. In recent years, LTIP's began to fall "out of favour" for a variety of reasons (including the requirement to disclose LTIP value in financial disclosure documents). As a result, we have seen an increase in focus on short-term plans in the last couple of years. In addition, a wide-variety of "creative alternatives" have been created (including mid-term cash plans, stock appreciation rights, phantom plans, etc.).

The current wave has changed direction again

The world is in economic crisis, the Canadian regulators have implemented new compensation disclosure requirements and Boards are getting escalating pressure to carefully scrutinize pay programs to ensure that they are in the best interests of the company.

At the same time, the current “wave of uncertainty” is continuing to build. This is requiring the critical reexamination of business strategies and operations in both the short and long term. Under the new disclosure requirements for Named Executive Officers (NEO’s), it will no longer suffice to report the \$ value of cash bonuses, for example. Now a separate Compensation Discussion and Analysis (CD&A) must be prepared included descriptions of the incentive plans 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 that fact that many companies charted the course for their incentives 2 or 3 years ago, before the current storm washed out the economic assumptions of ongoing financial growth. As business 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 be working against your current initiatives by continuing to focus and reward “outdated” behaviours and results. For example, if your incentive plan incents increasing “Market Share” but the revised strategy focuses on “Operational Efficiency” you could send employees sailing off in the wrong direction.

Identify the Storm Warnings

While there are many different types and designs of incentive plans, the symptoms of an ineffective plan are generally very similar. The signs that your incentive plans are performing sub-optimally are:

- Tremendous “push-back” and surprise from employees upon distribution,
- Challenges from the Board or other key stakeholders
- Formulas that results in a proposed payout that the company cannot afford,
- “Windfall” payouts and/or “no payout” situations resulting from environmental factors that the employees could not effect,
- Treating the plan like it is part of base pay (i.e. entitlement),
- Failure of employees to shift their efforts to align with the new business strategy,
- Inordinate focus on a few, but not all, of your key business metrics
- Plan design not reflecting the realities of the current environment (e.g. economic slowdown, competitor changes, shareholder concerns, disclosure optics).

Diagnose the Severity of the Problem

There are 7 key design features which 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. On-going Monitoring and Communication

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

1. *Alignment with new Business Strategy and Current Business Environment:*

- When you analyze all of the pieces of the incentive plan, including how it is actually distributed, they should be incenting performance that is consistent with your new business direction and the economic realities of the organization (i.e. ability to pay).
- **Is the plan design still appropriate in the current business environment?**
 - As we've been discussing, "we're not in Kansas anymore Toto"!! Competitors are re-evaluating their programs, Directors will be asking more questions and YOU will likely be asked to provide input into the rationale for the performance metrics, formulae and payout levels! You will need to have up-to-date market data, get a sense for trends in shareholder concerns and, even if you're not a public company, become familiar with the new disclosure requirements (as they're going to put pressure on almost all corporate incentive plans.
 - Is there a need to shift the focus to long-term from short-term because of the current financial challenges that many organizations are suffering?

2. ***Economics of the Plan:***

- **Have the plan(s) funding been carefully calibrated?**
 - Many incentive plan designers without a solid grounding in finance neglect to do the proper analysis to ensure the 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 the plan provisions allow for "claw-backs" when a financial restatement shows that the target performance was not actually attained?

3. ***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 further down the horizon to solid landmarks is often a way of focusing efforts on meaningful goals. With the current economic turbulence creating muddy water, longer-term goals are often much clearer and a means of moving forward to ensure the structure is in place for success in the future.
 - b) **The use of a "balanced" group of performance measures** – Regardless of whether a company uses a 'balanced scorecard' or a more formula-based approach, it is critical that the incentive plan incorporate a variety of measures. Measures which encourage short-term profit (e.g., increased revenue) need to be 'balanced' with those that ensure future value is simultaneously created (e.g., 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 that 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 of the organization will be able to see how their job and their performance help to drive business strategy.
 - d) **'Line of sight'** – employees should be able to have some impact on the performance measures used in the incentive plan. Obviously external factors (e.g. commodity prices, weather, wars, etc.) may have an effect that no one in the organization could either control or take credit for. But employees should be able to understand that they can affect the attainment of the performance goals with their performance and/or mitigate the effects of these 'uncontrollable' external factors.

4. **Formulae/Scorecards:**

- How complex are your current incentive formulae?
 - The general “rule of thumb” is to keep the plan design **as simple as possible**. Typically, everyone involved in the initial design process starts out with the objective to keep it simple. However, as the design process unfolds, and details about the business strategy and objectives come to light, a desire to capture everything the business needs to accomplish emerges.
 - Using the balanced scorecard methodology as the foundation for incentive plan design can facilitate this process. The strategy map (or “story”) makes the linkages between performance measures much more clear to employees. Thus, the need to limit the number of 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.

5. **Participation:**

- Plan participation is an important consideration. Companies have been pushing their incentive plan 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 that employees can tolerate or desire is an important consideration when determining the organizational levels to include in the plan.

6. **Stakeholder Buy-In:**

- Have your key stakeholders (**e.g. 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. In order 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 that top management is not only on board, but, in fact, are the key drivers, of their 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. Proactively communication with key stakeholders will enhance the success of any incentive plan changes.

7. ***On-going Monitoring and Communication:***

- Employees are definitely feeling “set adrift” in this uncertain environment. The review and realignment of performance metrics, for example, is a prime opportunity to communicate and reinforce the new business focus and priorities. By literally “putting your money where your mouth is”, signals to employees that we are going in a new direction, for example, and these measures are illustrative that new business plan. All stakeholders, as appropriate, should receive **communication before; during and after** any incentive plan changes.
- New challenges will accompany 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 that they can provide up-to-date revisions and/or trends in this turbulent environment.

Chart a New Course

Once you have completed your diagnosis and have identified the incentive plan design features that require some 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 the incentive plans are changing to provide alignment with the new business strategy;
 - Oversee and guide design and implementation;
 - Review the ongoing effectiveness of the 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 behaviour.
 - 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’s understanding of business strategy and objectives, and gauging the likely impact of the updated incentive plan on employee behaviour and performance.

3. Develop a **navigation course** for redesigning and implementing the incentive 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 using several scenarios resulting in a portfolio of plans (short, mid and long term), using a number of different performance measures including non-financial.
4. Avoid getting sent back to ‘walk the plank’:
 - **Check in frequently** with the group that will ultimately be responsible for approving the revised plan design. Too often, the design team proceeds on the assumption that the executive team is “on the same page”, only to find out at the eleventh 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 any time soon, it is important to consider the following factors:

1. Recognize that 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 pays 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 continually 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 the 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 “sea worthiness” of your incentive plans. Even if your incentive plans appears “ship shape”, it will be important to continue to schedule “alignment reviews” to ensure that 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 the kind of attention from stakeholders (and not in a good way!!) So ‘batten down the hatches’ and begin to diagnose your incentive plans to ensure that 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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