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## Jacksonville Compensation Association

### Designers Guide to Short-Term Incentives

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# Overview

- Introductions
- What is an Incentive Plan?
- Establishing the Plan's Purpose
- Designing an Incentive Plan
  - *Eligibility & Participation*
  - *Performance Measures*
  - *Award Structure*
  - *Source of Funds*
  - *Implementation/Communication*
- Design Checklist

# Incentives are all About Pay-for-Performance

**An incentive plan provides a disciplined approach to focusing and rewarding specific behaviors, activities, and results through cash awards tied to predetermined performance goals**

# How is a Broad-Based Plan Different from an Executive Plan

- Smaller dollars per person but larger dollars overall
- Less obvious tie between pay and performance
- Metrics of performance are not as concrete
- Differentiation from merit increase is important (i.e. double counting)
- Eligibility becomes an important issue

## Before beginning the design process, there should be consensus on the plan's purpose

1. What is **the impetus** for developing the plan?  
*Change in competitive strategy? Pressure for cost reductions or productivity improvement? Deliver appropriate pay opportunity?*
2. How will things be **different** if the plan is successful?  
*What business outcome(s) are we trying to achieve?*
3. What is the primary **purpose** of the plan?
  - *Change business **results***
  - *Change **behaviors***
  - ***Attract and retain** employees*

**PURPOSE GUIDES MANY DECISIONS IN THE DESIGN PROCESS**

# So Where Do You Begin?

Primary Purpose	Appropriate First Design Step
Change Business Results	Measures
Change Behaviors	Eligibility
Attract and Retain Employees	Eligibility

**THE PROCESS MAY NOT BE LINEAR;  
“START ANYWHERE, GO EVERYWHERE”**



# The Incentive Design Process



# Eligibility & Participation

## Three Factors Should be Considered

1. **Business Necessity:** Which positions can influence the performance of the company and can be measured?
2. **Equity:** Which positions/individuals need to be included/excluded to avoid justifiable charges of unfairness?
3. **Competitive Practice:** Which positions typically are eligible for incentives at other companies?



# Performance Measures

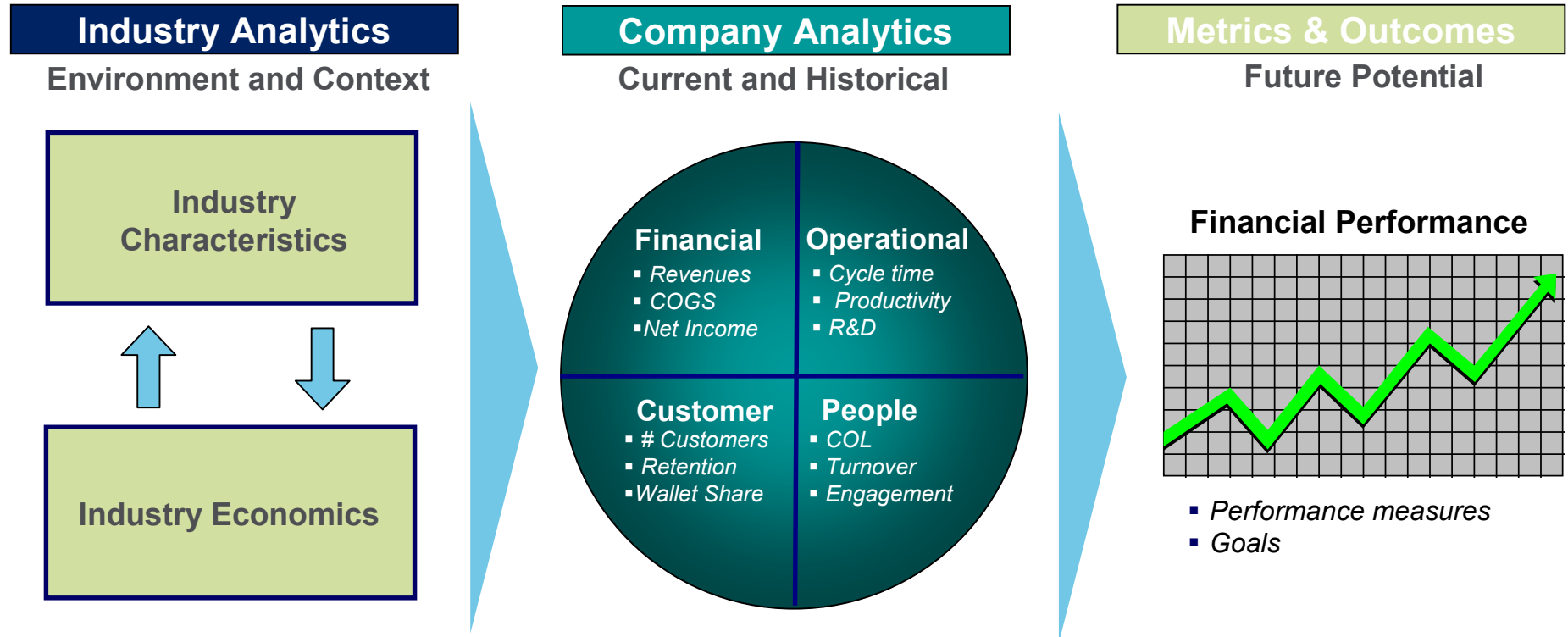
## Four important measurement issues must be addressed

1. **Level of Measurement:** At what organizational level should performance be measured? How should measures be weighted?
2. **Feasibility:** What is the likelihood that employees can influence the measure?
3. **Results:** What results should be measured?
4. **Time Frame:** Over what time frame should performance be measured?

# Companies Are Rethinking Their Annual Incentive Programs, Particularly Performance Measurement

- Traditional earnings metrics are being supplemented with cash flow, cost reduction and operational focused goals
- Increased use of discretion in determining payouts in order to address goal-setting uncertainty
- Wider incentive payout zones to increase likelihood of some level of payout and maintain motivational value of plan
- Generally no reductions in incentive targets
- Shorter semi-annual performance measurement periods

# Three tiered business analytics approach will help determine metrics and performance goals



## KEY QUESTIONS

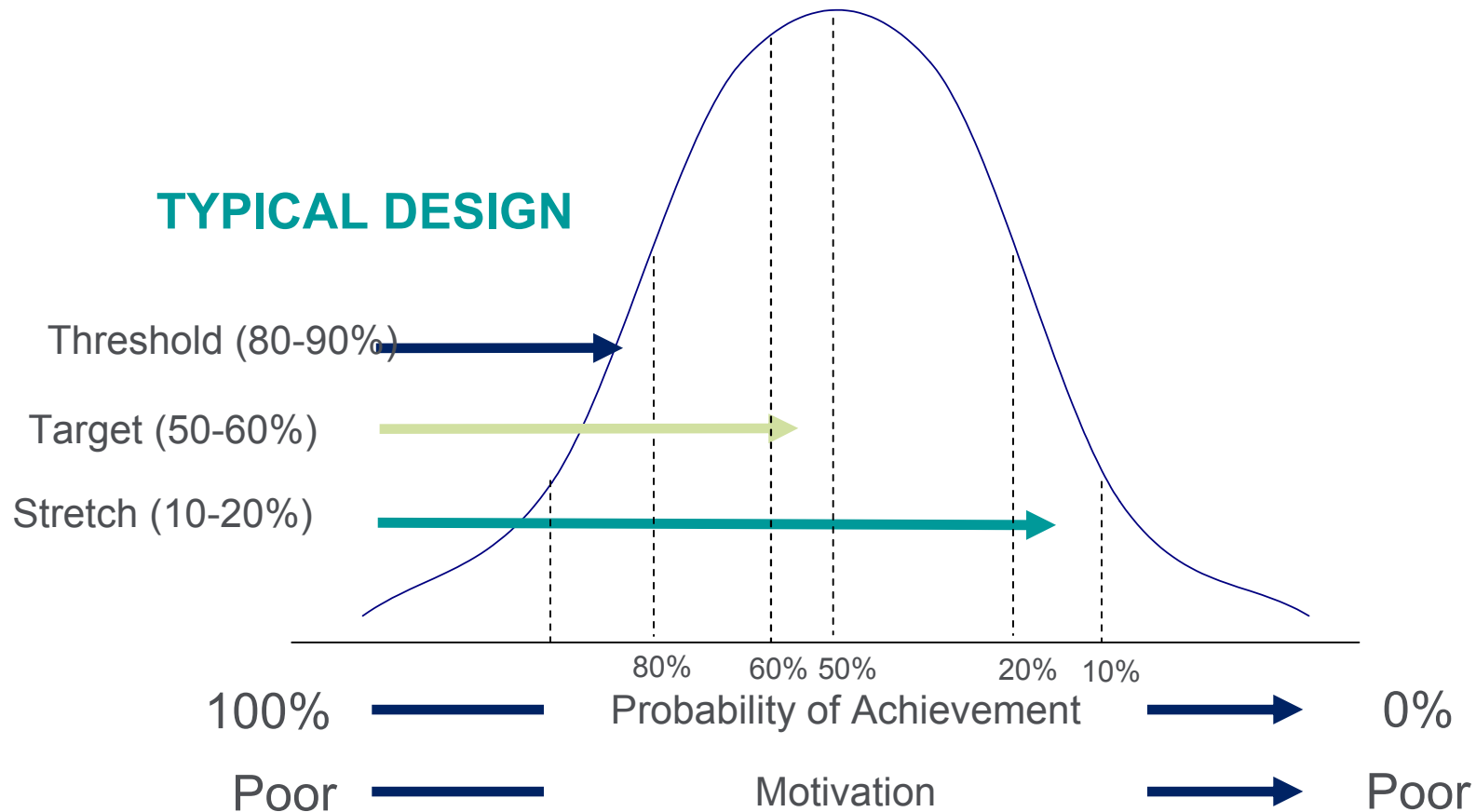
- How is the industry structured?
- How do companies in the industry make money?
- How is the company performing in key dimensions?
- What are its opportunities?
- What are the key performance metrics?
- What are optimal goals for the company?

## Sample Quantitative Measures

Category	Examples
Income Statement	<ul style="list-style-type: none"> <li>■ Sales/Net Sales</li> <li>■ Cash Flow</li> <li>■ Gross Profit/margin</li> <li>■ Operating Margin</li> <li>■ Net Income</li> <li>■ EBIDTA</li> </ul>
Financial Ratios	<ul style="list-style-type: none"> <li>■ Return on Assets</li> <li>■ Return on Equity</li> <li>■ Return on Capital</li> <li>■ Return on Net Assets</li> <li>■ Return on Sales</li> <li>■ Earnings per Share</li> </ul>
Operational Measures	<ul style="list-style-type: none"> <li>■ Productivity (ratios)</li> <li>■ Time-to-market</li> <li>■ Controllable and total cost</li> <li>■ Defect rate/production yields</li> <li>■ New product intro rates</li> <li>■ Technology coverage</li> </ul>
Customer Measures	<ul style="list-style-type: none"> <li>■ Customer satisfaction</li> <li>■ Customer loyalty/retention</li> <li>■ Market share</li> <li>■ Channel growth</li> <li>■ Customer share</li> <li>■ Customer growth</li> </ul>

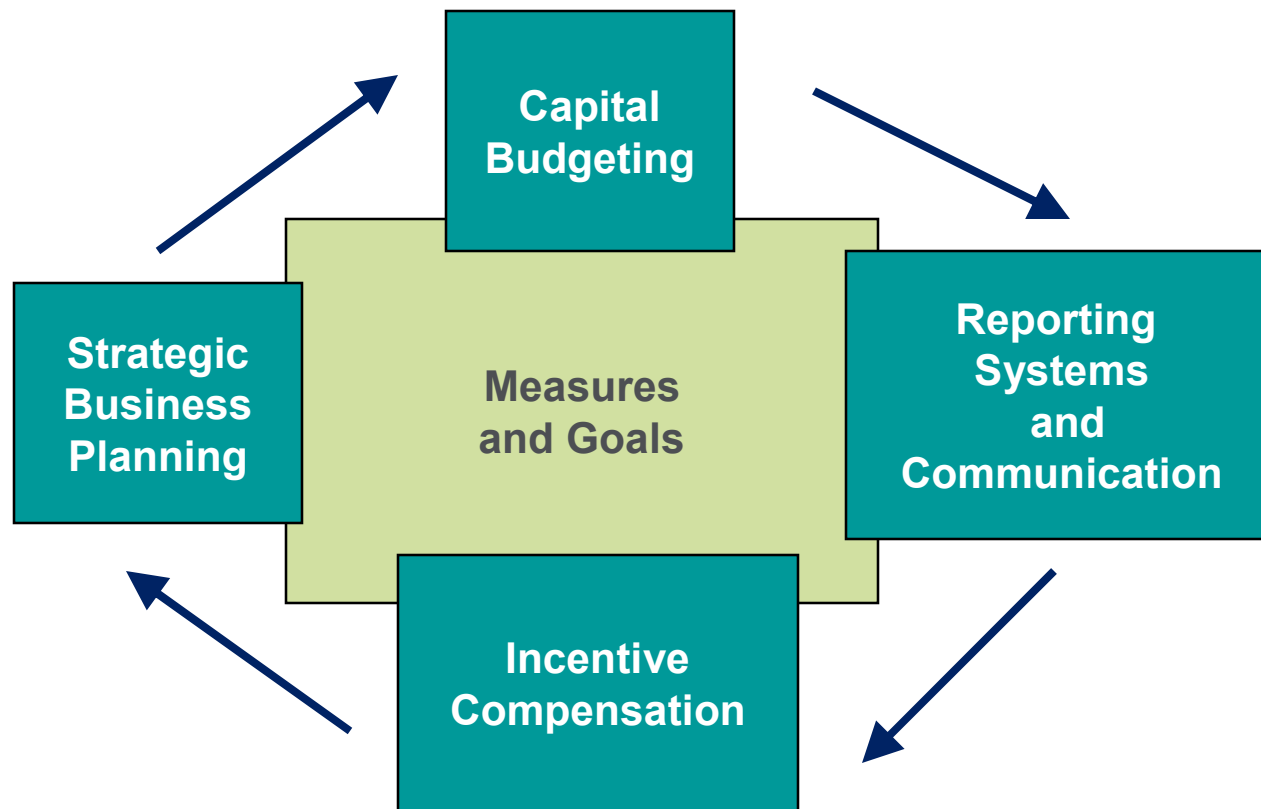
# How Hard Should it be to Hit Target?

THE FOLLOWING DISPLAYS THE “RULE OF THUMB” FOR PROBABILITY OF ACHIEVEMENT IN ANNUAL INCENTIVE PLAN GOALS



# Bringing It All Together

**IDEALLY, A COMPANY'S APPROACH TO SELECTING PERFORMANCE GOALS ARE CONSISTENT THROUGH ALL PRINCIPAL BUSINESS AND MANAGEMENT PROCESSES**





# Award Structure

## Structure--Three Primary Components

# SIZE

# Leverage



# *Timing*

# Award Size—Target Incentive Pay

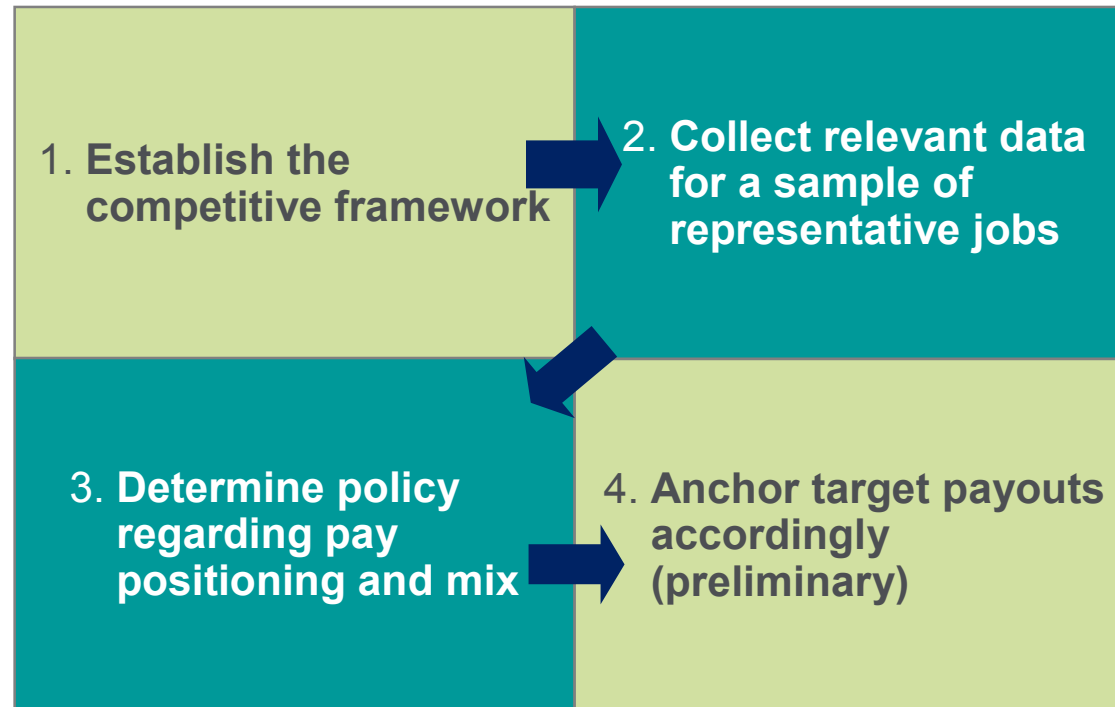
## FOUR FACTORS TO CONSIDER

- 1. Competitive Practice:** What levels of total compensation opportunities (salary plus incentive) are typically available in competitive marketplace in similar jobs? What are typical median target incentive levels?
- 2. Internal Equity:** What size incentive awards make sense relative to:
  - a. Internal structure, and*
  - b. Opportunity for people with similar skills and jobs in other organizations*
- 3. Affordability:** Is the cost of incentives at target reasonable on an absolute and relative basis? (ROI)
- 4. Significance to Recipients:** Are target awards large enough to be meaningful to plan participants?

# Award Size *continued*

## FACTOR 1: COMPETITIVE PRACTICE

**Policy**                      **Analytical**



**THIS ASSESSMENT INVOLVES TWO “POLICY” AND TWO ANALYTICAL STEPS**

### FACTOR 2: INTERNAL EQUITY

#### “Due diligence”

1. **Non-Benchmark Jobs:** Set proposed targets for jobs that cannot be market priced.
2. **Parsimony:** “Smooth” target award structure to minimize illogical gaps.
3. **Hierarchy:** Test targets against others at similar levels in the organization.
4. **Line of Sight:** Consider larger awards for positions with greater potential impact.

## Award Size *continued*

### FACTOR 3: AFFORDABILITY

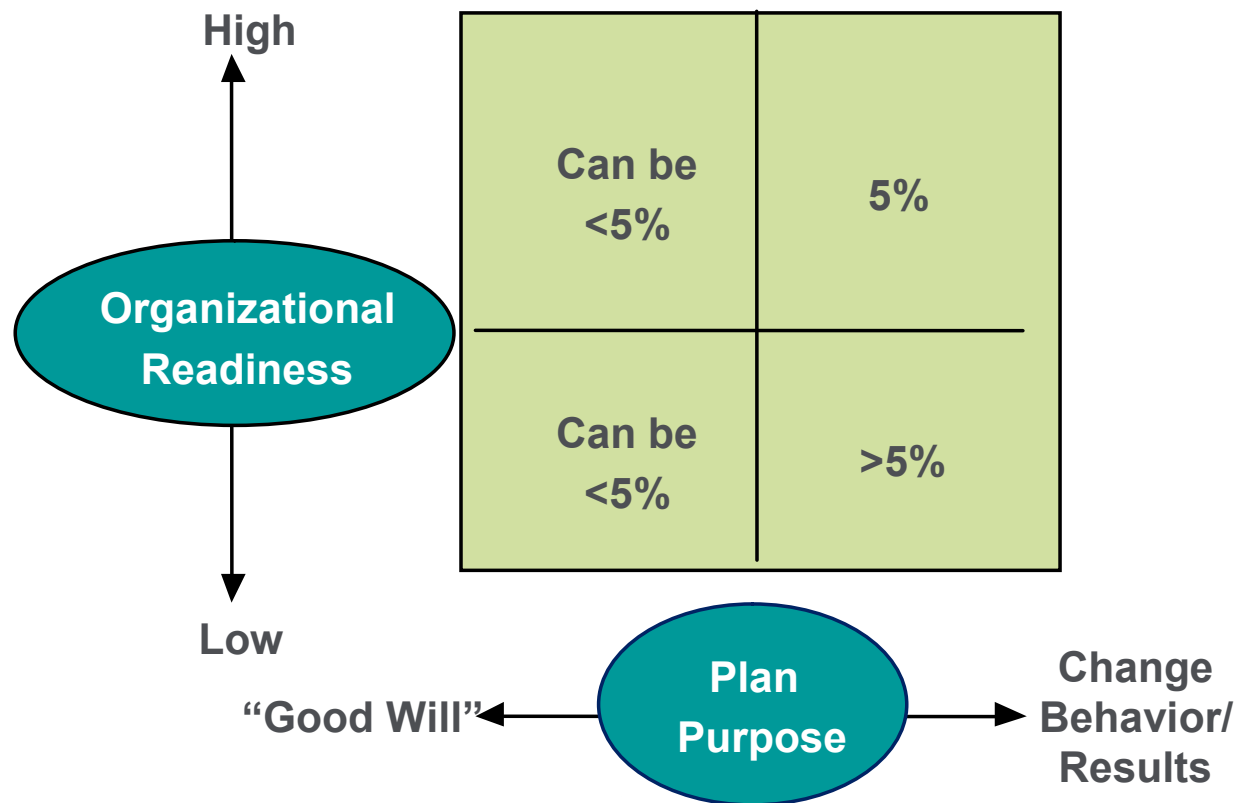
#### Modeling

1. **Create a spreadsheet or database** containing all current pay data for eligible employees.
2. **Add proposed target award sizes** (as variables that can easily be changed).
3. **Build in assumptions** about base pay increases, turnover, grade changes, etc., that may affect the actual size of target payouts by year-end.
4. **Calculate** total projected **cost of payouts at target**.
5. **Calculate** projected cost of payouts under several performance **scenarios** (both likely and unlikely).

# Award Size *continued*

## FACTOR 4: SIGNIFICANCE TO PARTICIPANT

### “Rule of thumb” guidelines



# Incentive Plan Leverage

- Plan leverage describes the **degree** to which higher incentive amounts can be earned for higher performance
  - *Leverage often increases in management plans putting more pay at risk*
  - *Often less leverage in broad-based incentive plans*
- The example below illustrates **how a payout can adjust** based on performance above/below target

Percent of Target	Payout as Percent of Target
80%	50%
100%	100%
120%	200%

**Double Leverage**

# Timing of Award Payment

## THREE FACTORS TO CONSIDER

1. Rationale for Measurement Time Frame
  - a. **Conservative:** *Set beyond point at which results are known: Consider mid-period “advance” payments*
  - b. **Aggressive:** *To encourage timely reward: Consider partial deferral of payment*
2. Administrative Considerations: Time required to collect data, assess performance, calculate awards, get approvals, coordinate with payroll, communicate.
3. Alignment with Other Payments: Pros/cons.



# Source of Funds

# Plan Funding Options

- 1. Existing Compensation Costs:** Incentive is funded by allocating dollars earmarked for other forms of compensation
- 2. New, Incremental Costs:** Incentive costs are either:
  - a. Self-Funded (plan “pays for itself”), or*
  - b. Budgeted from other sources*

# Three factors must be considered to make the funding decision

- 1. Results of Competitive Analysis:** Is there a gap between current pay opportunities and competitive targets?
- 2. Purpose of the Plan:** Is the Plan's primary purpose to improve financial results, attract and/or retain talent, or change behaviors?
- 3. Financial Impact of Proposed Measures:** Can the plan pay for itself?

## Implementation/Communication

- **Develop strategy for implementation—nature of plan (e.g., broad-based vs. executive) will drive the approach**
- **Ongoing communication** strategy is critical
  - *Need to generate enthusiasm*
  - *Desired behavior and outcomes should be clearly communicated*
  - *How frequently will performance to measures be communicated to participants during the plan year?*



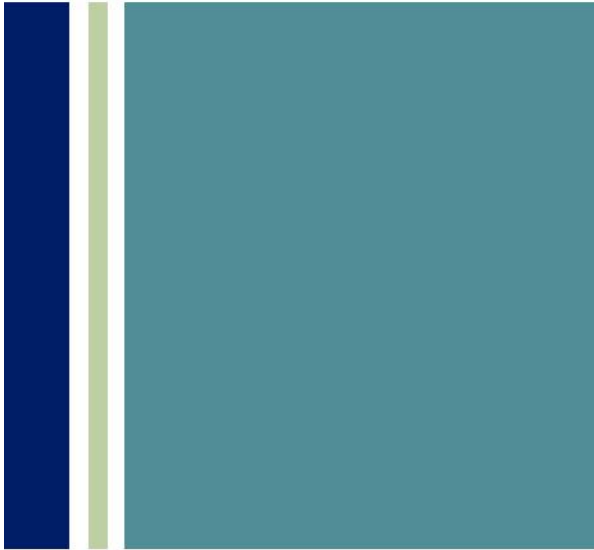
# Design Checklist

## Wrapping up...

### YOU HAVE FOLLOWED AN EFFECTIVE DESIGN PROCESS IF YOU:

1. **Clearly articulated the Plan's primary purpose**
2. **Decided who will be eligible** for participation in the Plan
3. **Established the case for measuring performance** at the proposed organizational level
4. **Identified specific results** (measures and goals) to be measured
5. **Determined the measurement** time frame
6. **Determined how large individual awards will be** at "target" performance levels
7. **Determined the range of potential payouts** (as a percent of target)
8. **Decided exactly when awards will be distributed** and how they will be funded
9. **Developed a communication approach**

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**Questions?**



# ■ Select Data From Our 2009/2010 U.S. Strategic Rewards Survey

# 2009/2010 U.S. Strategic Rewards Survey

- 14th Annual Strategic Rewards study
- Study fielded between April and May 2009
- 235 U.S.-based companies participated
- Cross-industry representation of organizations with at least 1,000 employees
- Select data from the August issue of Watson Wyatt's bimonthly survey series "Effect of the Economic Crisis on HR Programs"
  - 175 large U.S.-based companies participated
- Employee data reflect responses of 1,300 full-time workers at organizations with more than 1,000 employees

# Key findings: Few companies have been immune to the effects of the downturn

- Organizational restructuring pervasive and deep
  - Many rounds of layoffs since the downturn began
  - Cost-cutting measures employed to avoid layoffs and to augment them
- Reward programs affected
  - Merit budgets low but expected to rebound
  - Annual incentive plan funding reduced
- Plans to begin reversing many cuts
  - Most plan to begin within next 12 months
  - Restoration will be a long-term process
- Negative impact on employee engagement
  - Greatest impact on high performers
  - Retention risks loom as we move toward recovery
- Adverse impact on Quality and Customer Service
  - Employees believe recent changes affecting quality and customer service
  - Employers not as concerned

# Recession has reduced funding for annual incentive plans for broad-based employees

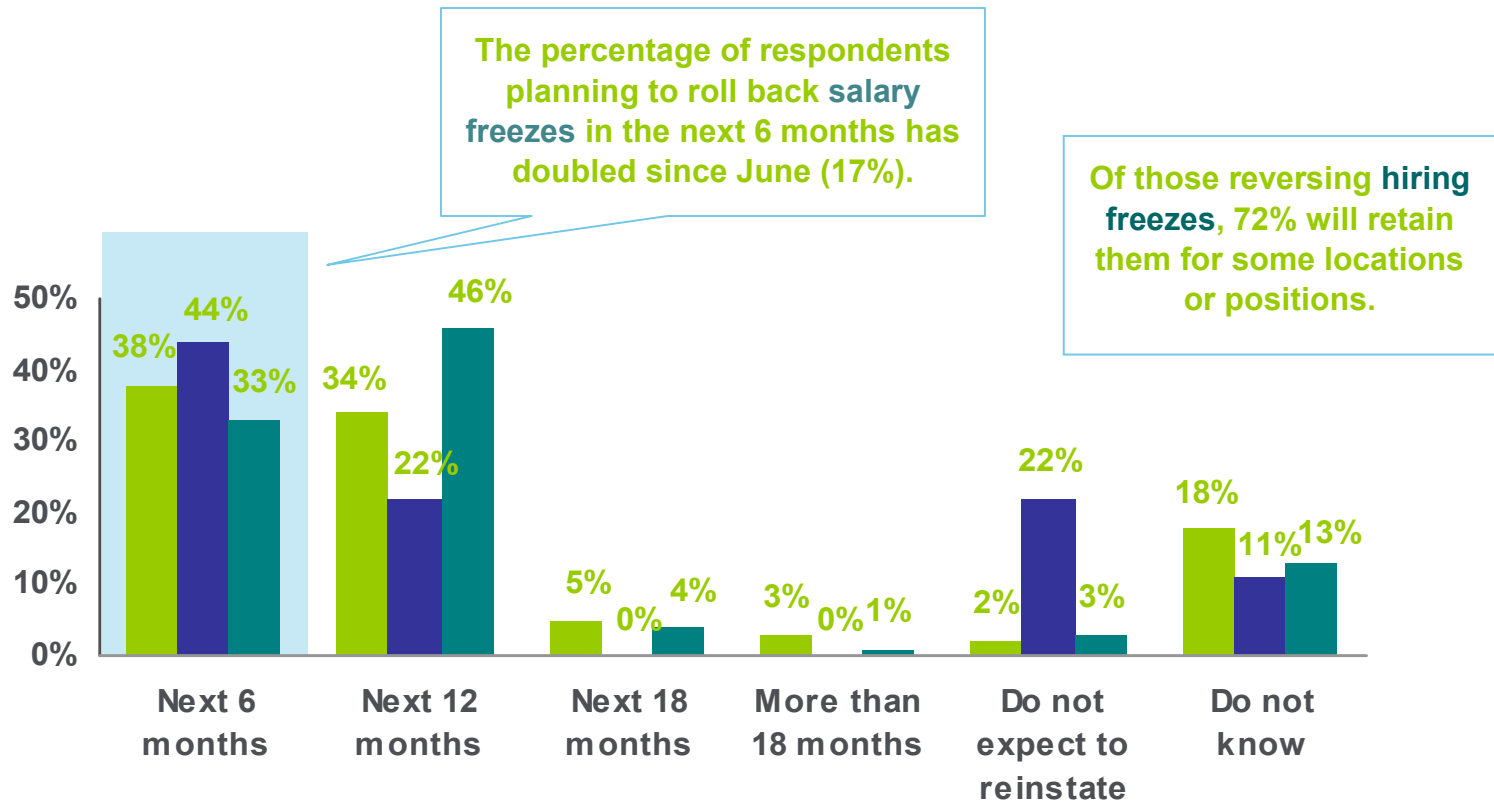
## STI funding down over the past 2 years

STI funding levels down from 99% of target in 2007

	Funded last year	Expect to fund this year
Median STI funding	81%	76%
Mean STI funding	76%	68%

\* As reported in the *Effect of the Economic Crisis on HR Programs – Update: August 2009*

# Most companies plan to reverse salary freezes, hiring freezes and salary reductions over the next 12 months



	Hiring freeze	Salary reduction	Salary freeze
Percent that made change	61%	16%	61%

\* As reported in the *Effect of the Economic Crisis on HR Programs – Update: August 2009*

# Significant decline in line of sight among top-performing employees

- Significant declines in line of sight indicators for top performers
  - 43% believe the performance bar for earning bonus has been raised
  - 32% indicate company financial performance expectations have increased

Drop in line of sight for top-performing employees (2009 vs. 2008)

	Percentage change
My performance goals are linked to company's strategy and goals	▼ -20%
My supervisor ties my rewards (compensation) to organizational performance	▼ -37%
My performance objectives are motivating	▼ -24%