Chapter

8

Designing Shorter-Term Cash Incentive Programs: Getting the Basics Right

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Those interested in understanding stock-based compensation find themselves faced with a barrage of buzzwords describing various types of plans: stock options, employee stock ownership plans (ESOPs), employee stock purchase plans (ESPPs) . . . the list goes on. But the topic of incentive compensation, which rightly includes stock-based plans though it typically refers in practice to shorter-term cash-based programs, has its own vernacular: variable pay, lump sum awards, bonus, commission, gainsharing, profit sharing, and more. I have even seen this proliferation of terminology lead to debates over "risk sharing" versus "success sharing."

Compensation management comes down to this challenge: effective allocation of an organization's financial capital to its human capital. Every organization, whether for profit or not-for-profit, private sector or public sector, faces this challenge. In some manner and in some form—cash, stock, goods, and services—capital must be allocated to ensure people will accomplish the work of the organization.

Increasingly our human capital means more than employees; it includes other workers such as contractors, consultants, and other professional advisors, making it necessary to consider how we allocate capital to the organization's *workers*, not just its employees.

Developing an allocation plan requires determining who receives the capital, in what amount, based on what criteria, and then integrating this process with other management systems.

Employee ownership discussions typically revolve around the allocation of stock, but it is possible—indeed, sometimes preferable—to use cash-based programs to reinforce ownership processes, including information-sharing, empowerment, and participation. This chapter will help readers understand how to use shorter-term cash-based incentive compensation programs to reinforce ownership behaviors and create an ownership culture.

Allocating Capital: Stock-Based Plans

When we allocate financial capital to workers in the form of stock, some aspects of plan design are easy to resolve. While there are many accounting, tax, and securities law complexities, the performance measurement is usually predefined: stock price. Over time, total return to shareholders (stock price appreciation plus dividends) determines exactly how much compensation will be paid, linked directly to company performance. This inherently addresses three fundamental issues of reward strategy:

- *Performance measurement,* defined as total return to shareholders.
- *Economic consequences of performance:* in most plans, rewards are linear with increases in shareholder value.
- *Funding* provided by the marketplace (public or private) when the equity position is liquidated.

Many organizations, unable or unwilling to use actual equity for compensation, attempt to emulate a stock-based program through a long-term cash bonus plan, which often gets labeled as phantom stock or stock appreciation rights (SARs).[1] To manage an organization effectively, however, we need to focus on shorter-term measures, shorter-term behaviors, and shorter-term performance as well. We can choose stock or cash as the form of reward delivery. When we consider allocating cash or stock based on shorter-term performance (weekly, monthly, quarterly, but most commonly annually), we run into some difficult issues.

Performance Measurement

The first issue to resolve is performance measurement. If an organization embarks on an incentive compensation development process without knowing, in concept, the performance basis, the effort will be ineffective. Once we allocate stock to a worker, we know the ultimate value of that reward will be based on the stock price. The only other decisions are how many shares to allocate and what criteria will determine share allocation. But when we allocate cash it must be based on some behavior, as gauged by some measure or measures, over some period—and none of these has an inherent design answer.

For example, when the total quality management (TQM) movement began to spread widely in the early 1990s, many organizations modified their plans to reward quality, which led to failed programs and caused many to question the effectiveness of incentives. The unfortunate answer is that the wrong question was being asked. Quality is not the ultimate objective of an organization, but a strategy for meeting objectives. Clarifying objectives is the critical first step in defining performance measures as a basis for incentive compensation.

I have a simple analogy to illustrate the core issues of performance measurement (figure 8-1). Even for those who are not sports fans, this model clarifies the key issues in developing effective performance measures for shorter-term incentive programs. It contrasts the variety of performance measures in a typical business organization with those of a professional football team.

The *ultimate* objective of a for-profit entity is total shareholder return, not market share, worker satisfaction, or quality products, which are strategies. To link incentive compensation to performance measures, we must understand the types of measures are *critical* to achieving the organization's ultimate objectives. And there are many *interim* measures that contribute to higher-order measures.

The Hierarchy of Performance Objectives

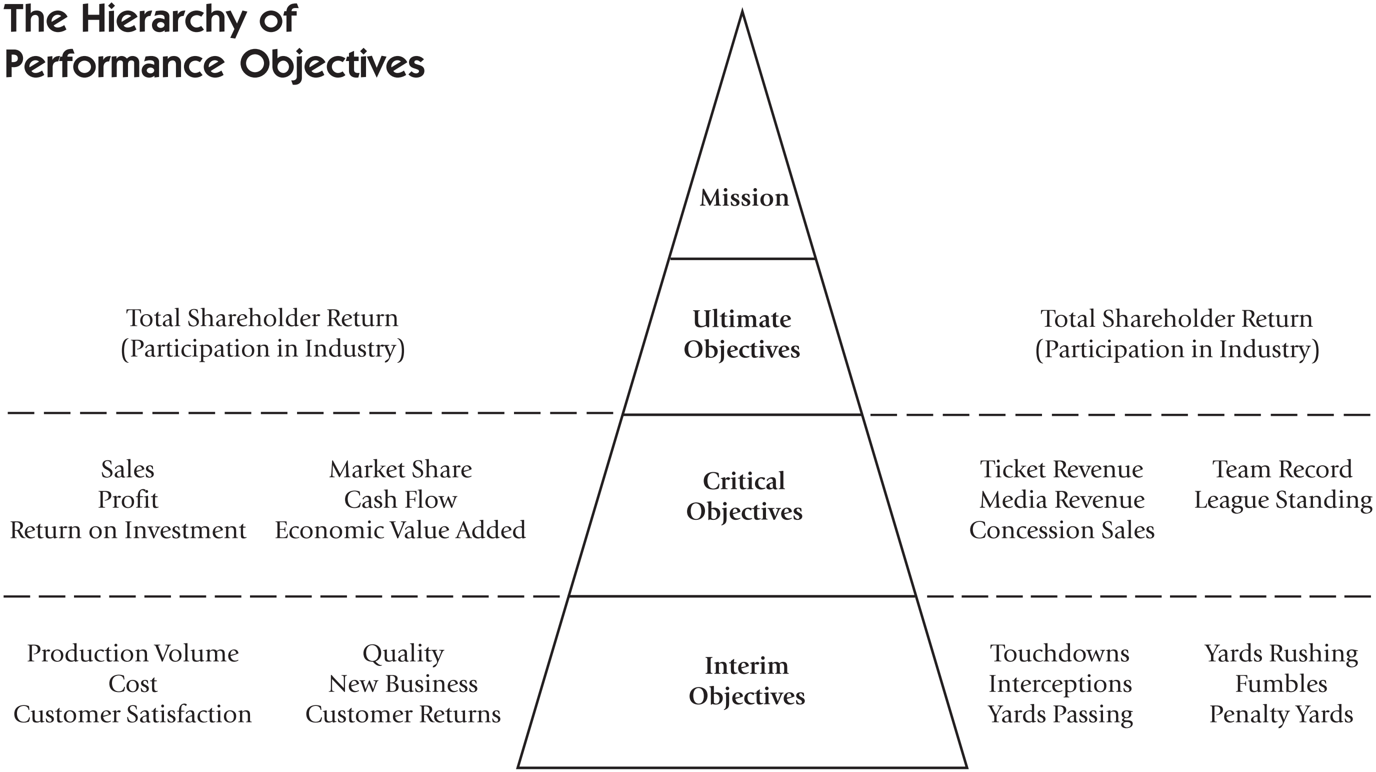

Figure 8-1. Hierarchy of performance objectives

Measuring Organizations and Individuals

The owners of any business, including a football team, have a dual agenda. Although they certainly want and expect a competitive return on investment, they typically direct their investment not only to a potentially profitable venture, but one in which they're interested. So they have two goals: shareholder return and industry participation. Owning a football team can be very profitable, but many wealthy investors choose instead to sponsor an auto racing team or invest in oil drilling operations to achieve their investment objectives.

But a football team owner would have little success in approaching the defensive linemen and telling them their job is to ensure a 25% return on the owner's investment. Imagine the blank stares. That is, in fact, their job, however. Sadly, this is no different than an electric utility that tells its linemen (who climb poles rather than tackle opponents) that compensation from their new stock option plan is based on increases in stock price, which depends on earnings per share (EPS) growth. In both cases, the shareholders are attempting to link rewards to the organization's ultimate objective: increasing shareholder value. And in both cases the worker is unlikely to understand how tackling quarterbacks or repairing power lines affects return on investment.

Clearly, certain measures will lead to increases in value if managed properly. But the variety and complexity of these factors may still be beyond many workers' lines of sight. The defensive tackle still may not see the connection between his performance and concession sales volume (although professional athletes are quickly catching on to the commercial appeal of their brand). But the defensive tackle's performance—continued thrashing of the other team's players—may be what generates the excitement that entices fans to attend or watch the game, thus increasing overall revenue.

When we talk about creating an ownership culture, that is really the focus. How do we get every worker to understand how he or she affects overall performance? How do we help flight attendants understand their impact on the company's stock price, then link compensation to their behaviors accordingly? We typically use stock as our currency when we pursue this strategy. But that doesn't have to be the case. Many companies are unwilling, or unable, to use stock as the primary currency for performance-based compensation, yet succeed in creating an ownership culture.

Regardless of company size, an environment where employees feel the impact of ownership economics—upside and downside—is possible without the use of equity. While this chapter will not explore the role of related processes such as information sharing and participative management, these strategies need not be any different for a quarterly revenue sharing plan than for a retirement-oriented ESOP or stock option plan with a four-year vesting schedule and ten-year term.

Designing effective shorter-term incentive programs requires understanding and clarifying the ultimate, critical, and interim objectives along with the responsibilities for achieving them, then tying them to significant economic consequences for workers.

Understanding Incentive Alternatives

Management compensation plans were the source of performance-based cash compensation, just as they were the origin of equity-based compensation. Generally, the higher a worker is in the management hierarchy, the more performance measures lean toward ultimate objectives; the lower in the hierarchy, the more focus on critical or interim objectives (figure 8-2). From a financial perspective, the question is where we draw the line on the income statement. Senior management is responsible for total return on capital and is directly involved in managing both return and capital. A sales manager may have responsibility only for revenue, perhaps gross margins.

When we extend this to all workers, we have the proliferation of buzzwords (figure 8-3) we've been subjected to over the years. Some have emerged recently while others date back to the early part of the century. These result from attempts to resolve the issues of performance measures and organization levels in developing performance-based reward programs. Organizations considering performance-based cash compensation should not be intimidated by this plethora of terms. My clients' experiences show

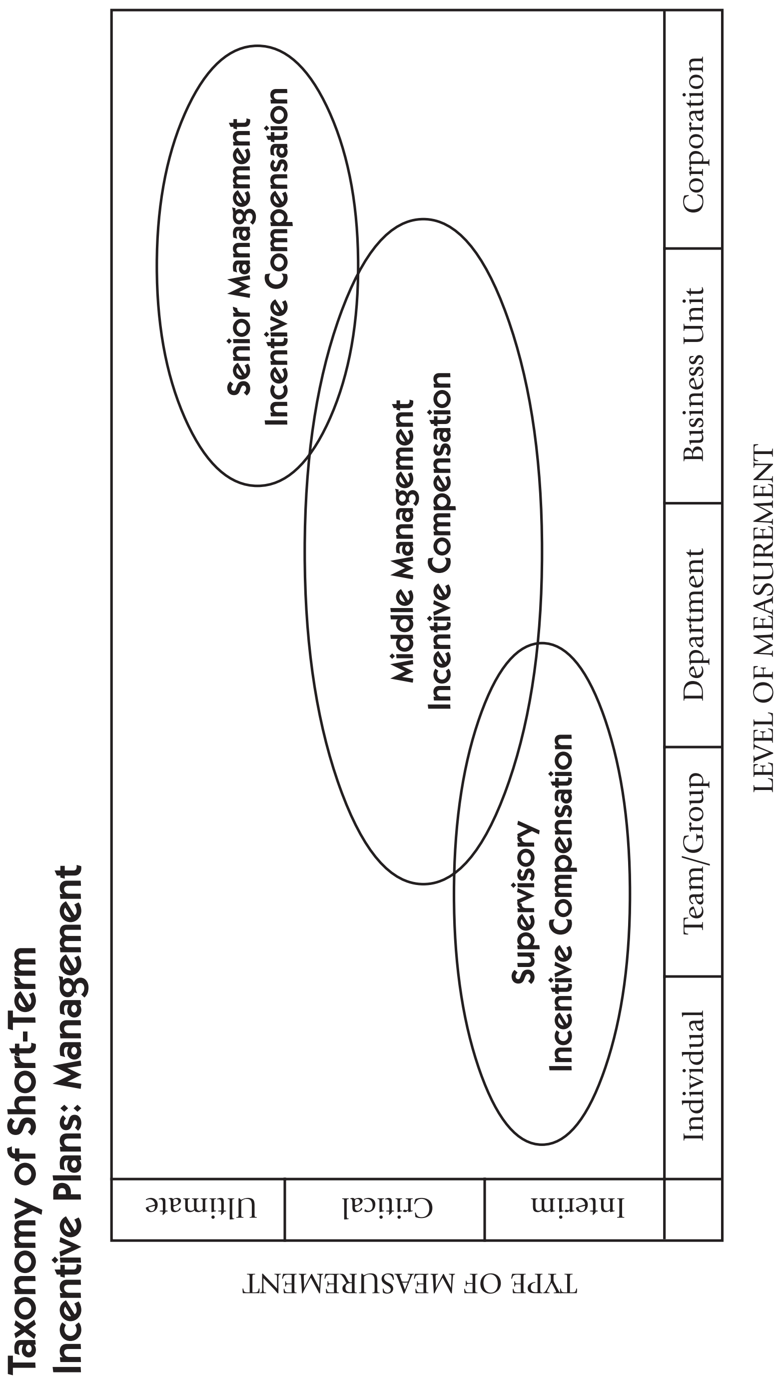

Figure 8-2. Taxonomy of short-term incentives: management

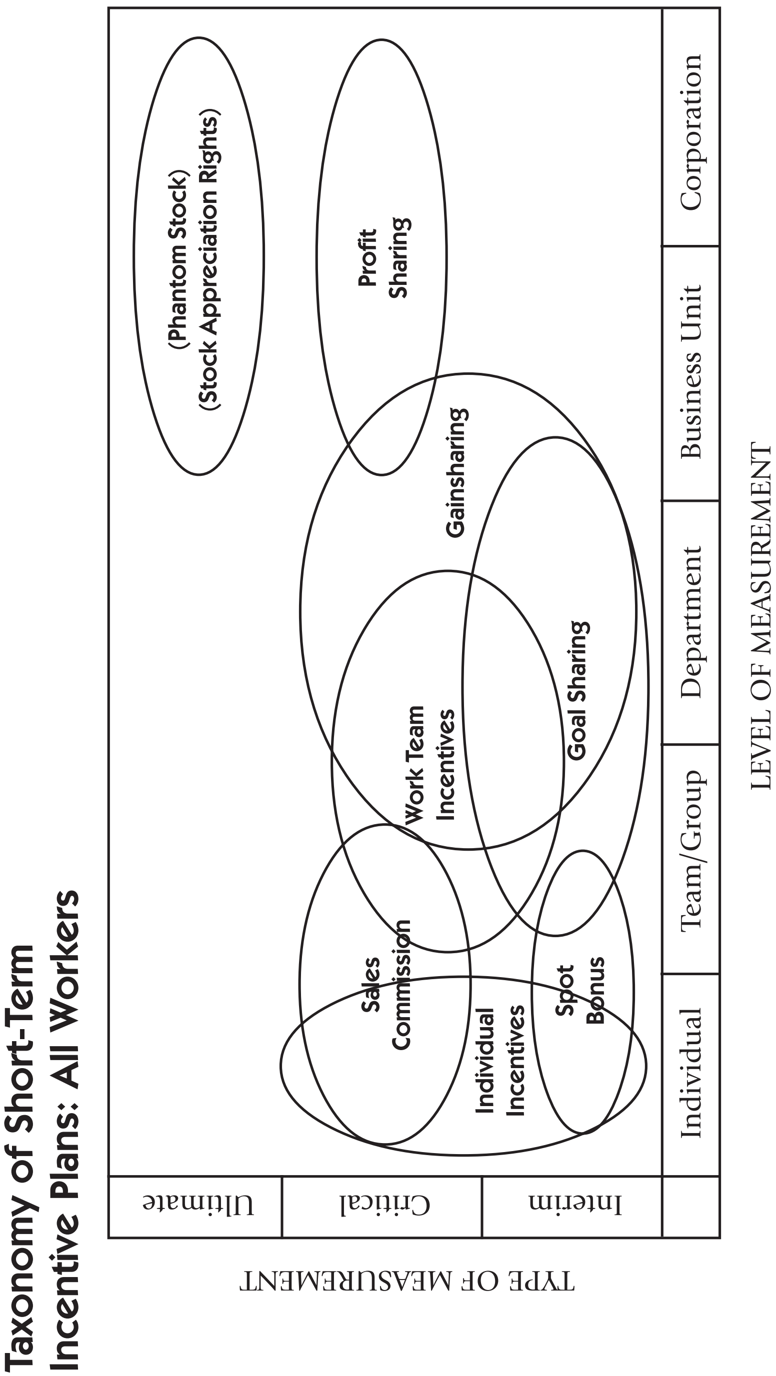

Figure 8-3. Taxonomy of short-term incentives: all workers

that a solid business-based process can lead through this maze of labels, and the final product—an effective performance-based reward program—can be named at the end. The key is understanding critical design decisions and the central issues of each.

Design Decisions

Many key design decisions in shorter-term cash-based incentive programs parallel those in the equity-based plan design process, not unlike the journalist's who, what, when, where, why, and how. But because we have more flexibility, the process requires more thought to arrive at the best answers, answers that address these components:

Participation. Who will participate in the plan? When we design an ESOP, there's little leeway. With a broad-based option plan, it is typically the same: all employees, maybe including nonemployee workers. The flexibility of shorter-term cash based programs allows a single program for everyone or just for some, or multiple programs including some or all employees. We need to determine whose behavior we are trying to change.

Performance Measures. Next, for that group or groups, what types of behavior do we seek and what outcomes do we want? What do we need them to do that they're not doing? What do we want them to stop doing? This requires defining the term *behavior* quite broadly. The first behavior a worker exhibits is responding to the company's need for workers, then interviewing, accepting the offer, and showing up the first day. The final behaviors are giving notice, winding down, leaving . . . and telling others about their employment experience after they leave.

Between the beginning and end are the behaviors we typically seek to change. But "performance" includes joining, staying, and leaving as well as actual contributions to productivity on the job. Hiring bonuses, retention bonuses, and severance packages are no less a part of shorter-term cash-based compensation strategies than profit sharing, gainsharing, and sales commissions.

Performance Measurement Level. At which level should we link performance? Corporate, business unit, division, department, work group, individual—or some combination? This is often a difficult decision as we attempt to balance line of sight with team orientation, and immediate impact versus long-term impact. The lower in the organization we go and the more we move from line to staff positions, the more difficult it is to resolve these questions. The chief financial officer should be tied primarily, if not exclusively, to company financial performance. But what about the controller? assistant controller? accounts receivable clerk? There is no easy answer to these issues, but the outcome must be consistent with all other organization philosophies and strategies. "We're all in this together" or "It's everyone for themselves." "I don't have control over that" or "We all have an impact on everything."

Performance Period. What is the relevant period for measuring performance? In most cases, a shorter-term cash incentive plan will have a performance period of one year or less. This convention in compensation design reflects the one-year horizon of the accounting cycle: annual financial statements, current versus noncurrent assets and liabilities, and so on.

We need to provide rewards on a cycle consistent with the organization's decision-result cycle, regardless of quarterly and annual fiscal periods. One company has sales representatives on a weekly commission plan—it sells advertising in a weekly publication, and the customer must decide each week whether to advertise again. Another company has technical people working on products with a two- to three-year development cycle and a two- to three-year market life. It pays milestone awards during development and a royalty-based award after the product is released. This decision will differ most by industry and company strategy and least by company philosophy.

Performance-Award Scale. How much pay for how much performance? If we have a simple percent-of-results formula—e.g., sales reps receive a straight commission of 5% of sales—this is self-defining. But relying on a simple linear formula may yield unexpected results. In fact, in my consulting experience this is one of the most common sources of compensation disasters.[2] More often, there is a business need to ensure a minimum performance level.

It is clear that we should be willing to pay our target incentive award at our target performance level. Below that, we must decide at what level we are no longer willing to pay. This defines the "performance threshold": the level where we consider the worker to have already been fully compensated for efforts and results through base salary, benefits, and other forms of reward.

Above the target level, we must determine when we are willing to pay 10% more, 20% more, 50% more, and so on. At what point, if any, would we be willing to double the award? Or are we willing to continue increasing the award proportionately as performance increases, with no cap? If the plan has multiple performance measures, this scale may vary among the measures. For example, an incentive compensation program with a revenue and operating margin matrix may have a threshold of 80% of target for sales and 70% for operating margin (table 8-1).

This decision drives the need to conduct detailed financial modeling of any proposed incentive program before implementation.

Funding. Where will the money come from? This critical decision defines not only the plan's financial operation but also the organization's reward philosophy. Some feel an incentive opportunity should be "self funding"—that is, incentive dollars become available only when performance exceeds an expected level; this is the basis for most gainsharing plans. Others believe the incentive is part of the total cash compensation budget paid for target performance; this is typical of most executive incentive and other target-based plans.

A formal funding formula may ensure a certain level of organization performance occurs before incentive awards are paid, as a control to ensure individual awards, in aggregate, do not exceed the organization's ability or willingness to pay. Alternatively, we can simply set individual award targets and, through detailed financial modeling, make sure individual and organization perfor-

Table 8-1. Example of a Revenue and Operating Margin Matrix for an Incentive Compensation Program

Operating Margin %	*Margin Award Factor*	*Percentage of Targeted Award Paid*				
13.0%	130%	65%	104%	130%	143%	156%
12.0%	120%	60%	96%	120%	132%	144%
11.0%	110%	55%	88%	110%	121%	132%
10.0%	100%	50%	80%	**100%**	110%	120%
9.0%	90%	45%	72%	90%	99%	108%
8.0%	70%	35%	56%	70%	77%	84%
7.0%	50%	25%	40%	50%	55%	60%
	Award Factor	**50%**	**80%**	**100%**	**110%**	**120%**
	Revenue (in Millions)	**$160**	**$180**	**$200**	**$220**	**$240**
	Percentage of Target	80%	90%	**Target**	110%	120%

mance levels, as defined in the plan, are well-integrated with the award structure. This is often not the case, however, and aggregate individual awards may end up above target while overall company performance is below target. This is more of a performance management issue than a compensation design issue and beyond the scope of this chapter, but it supports the need for thorough analysis of a plan's financial dynamics before implementation.

The funding method must be considered along with the performance-award scale. There may be no separate formula, or a formula may be based on a threshold, target, and maximum (table 8-2).

Allocation to Individuals. How do we determine the amount of payments to individual workers? Several alternatives are available for determining the amount. Most plans establish a target percentage of base salary and a percentage-of-salary performance-award scale, often combined with multiple performance objectives. But many still use a percentage of profit, an equal percentage of pay

Table 8-2. Sample Funding Formula

Return on Invested Capital	*Percentage of Target Incentive Pool Funded*
18%	130%
17%	120%
16%	110%
15%	**100%**
14%	90%
13%	70%
12%	50%
below 12%	0%

to all workers, or an equal dollar payment to all workers (usually only in unionized environments).

Award Payment. Once earned, when should the payment be made? Most shorter-term incentive programs pay awards soon after the performance period ends. This ensures a reasonably short period between performance and reward. The lag between performance completion and reward is typically extended only to collect and confirm the information on performance. For an annual plan, this may require completing the audited financial statements.

Regulatory Considerations

Addressing the above issues results in a blueprint for an effective shorter-term incentive program that holds all the potential of equity-based programs for creating an ownership culture. Before implementation, however, we must consider certain regulatory factors. Shorter-term cash programs are subject to substantially less regulation than stock-based programs, but several issues may render a conceptually effective plan design administratively or legally prohibitive:

- *Overtime Calculations.* The Fair Labor Standards Act and many state labor laws require inclusion of lump-sum incentive award payments in the base rate for calculating overtime.

- *Benefit Calculations.* Companies implementing new add-on plans should review all existing benefit programs to verify the definition of "compensation" and determine whether the current plan includes, or should include, incentive awards in the calculation. This may affect life and disability coverage, defined benefit and defined contribution plans, and other plans with pay-related formulas.
- *Securities Regulations.* Most cash-based incentive compensation plans with performance periods of one year or less will not be subject to securities regulations. But federal and state securities regulators are now moving toward characterizing any compensation plan based on company value as a security and are imposing certain reporting requirements.
- *ERISA.* The Employee Retirement Income Security Act of 1974, as amended, prescribes rules for any plan that may be characterized as a retirement plan. In practice, deferring payment of earned awards beyond the termination date or for more than two years may subject the plan to ERISA reporting requirements and even funding requirements.

Implementing and Integrating the New Plan

A new incentive program must be designed with the organization's current total economic reward system in mind. The reported failure of many incentive programs can be attributed to implementing a plan with an insignificant reward opportunity relative to the existing reward structure. Employers should remember that the current group of employees has come to work for the company for, presumably, an acceptable total compensation and employment structure. An added form of compensation, if expected to change behavior, must bear some relative and absolute measure of magnitude to existing rewards.

For example, a new incentive program that offers a target award of 3% of base salary is likely providing a 1% to 2% potential increase in total compensation. When compared, in the worker's mind, to the potential for a 3% merit increase, a 2% sick day bonus (five paid sick days per year), and other explicit and implicit rewards, a behavioral change is unlikely to occur. A more significant shift in total compensation may be necessary, e.g., freezing base salary for three years while adding 5% per year to the incentive pool, resulting in a more significant reward opportunity: 15% of base salary, which is then 10% below market average. This highlights the need for both "gain" and "pain" in a true ownership environment.

The first plan described above is considered an "add-on plan," where a company already offering a comprehensive compensation and benefits program offers to pay additional compensation. The latter is termed a "replacement plan," where a new incentive plan substitutes for some or all of an existing form of compensation. While a replacement plan is often perceived as more controversial and requires more intensive communication, it produces more significant and rapid changes in behavior.

Joining the Performance Revolution

The *Wall Street Journal* recently reported that in 1997, for the first time, the majority of US employees participated in a performance-based incentive compensation program having some portion of pay at risk beyond the stale "merit increase" in base salary. Although the *Journal* did not explain the criteria for this assessment, I know of no organization not already using or considering performance-based cash compensation for every employee. This is occurring in publicly traded companies, closely held companies, government entities, nonprofit organizations, and companies worldwide as capitalism spreads.

U.S. employers have spent decades experimenting with incentive compensation, with much written about the successes and failures. As with any management technique, many good ideas are implemented in the wrong environment or with little thought to the details, yielding failure. But it is hard to argue with the long-term success of the U.S. economy, which is based on a combination of cash and equity-based return directly related to economic performance. The economic system works, and capital is allocated among organizations to its most efficient use. The same system works just as well *within* an organization, but must receive at least a fraction of the thought and effort that has led to our nation's success. We will then be able to allocate the organization's financial capital to its human capital in a way that ensures economic success for all parties.

Notes

1. Fred E. Whittlesey, "Expanding the Phantom Stock Concept," *Compensation and Benefits Review*, November–December 1994.
2. Fred E. Whittlesey and Carol L. Maurer, "Ten Common Compensation Mistakes," *Compensation and Benefits Review*, July–August 1993.