

keep it simple

avoiding the pitfalls of overly complex incentive designs

The annual incentive plan is the single most important compensation tool for focusing senior management on critical near-term strategic and operational objectives. Such programs take many forms, limited only by the creativity of the designer — and that can also be their downfall. Complex designs with elements like discretion or performance multiples can effectively capture the nuances of a particular situation or strategy, but excessively complicated program metrics can have unintended consequences, including misunderstanding, miscommunication,

QUICK LOOK

- ➔ Annual incentive plan designs for executives working in the United States fall into one of four basic design categories: additive, multiplicative, discretionary or combination.
- ➔ With the ability to effectively handle up to four metrics in a straightforward manner, the additive design is clear, concise and easy to communicate.
- ➔ Combination plans typically incorporate specific funding triggers, or plan conditions, that must be met before any award is provided.

By Peter A. Lupo, Pearl Meyer & Partners



controversy over the criteria or level of payouts and proxy disclosure issues.

While complexity may be worth the trade-off in some situations, it is important to keep program designs as simple as possible, particularly in an uncertain economy, when forecasting performance beyond two months is a challenge. To that end, in recent months some companies have taken a fresh look at their incentive plans beyond setting new targets under existing metrics to see if structural changes are needed.

Conceptually, annual incentive plan designs for executives working in the United States fall into one of four basic design categories: additive, multiplicative, discretionary or combination. This article examines how each plan type works, in what situations it is most effective and whether it passes the simplicity test. It also offers tips on how to ensure the design of complex plans — when complexity is deemed appropriate — will support the desired outcomes.

Additive Designs

Additive designs are extremely simple designs in which executives who achieve even a single predetermined goal receive some bonus payout, regardless of their level of performance against other plan goals. For example, payouts might be based equally on revenue and profit, so that meeting one hurdle generates a 50-percent payout, and meeting both goals results in the maximum award. Generally, such plans can support up to four different metrics without overly diluting the focus on any one goal.

Individual goals also may be weighted, based on priority. However, if more than half the total award value is based on any one goal, the overall number of metrics should be reduced to no more than three to avoid losing focus. In general, if a performance

While complexity may be worth the trade-off in some situations, it is important to keep program designs as simple as possible, particularly in an uncertain economy.

measure has a weighting of 10 percent to 15 percent of the total or less, a company should revisit either the weightings or the number of measures being used. Alternatively, a plan might require threshold performance for one particular metric before any payout is triggered, regardless of performance against the other goals. For example, many companies require achievement of a threshold level of profitability before any award is funded.

This type of design is most effective where a company wants to reward for overall performance, without spotlighting a particular measure. For example, an additive design is effective for a company that wants to equally reward for profit and revenue growth — but not in situations in which the priority is meeting at least threshold performance on one specific goal. Consider: If a company has been

struggling with profit growth and misses that target, it may not want to pay out any bonuses, regardless of executives' performance against other goals.

Simplicity Test: Passed. With the ability to effectively handle up to four metrics in a straightforward manner, this design is clear, concise and easy to communicate.

Multiplicative Designs

Multiplicative designs also produce a bonus predicated on achieving specific goals, with the difference that performance results are determined by multiplying the final award level. No bonus is paid unless performance for every goal hits at least threshold level. For example, if Goal 1 performance is 120 percent of target performance, Goal 2 achieves 100 percent of target and Goal 3 achieves 75 percent of target, the final incentive would be 90 percent of the target award, which is the amount of bonus paid when overall performance meets target performance. ($1.2 \times 1.0 \times 0.75 = 0.90$, or 90 percent.)

This design introduces significantly more upside and downside leverage: High performance levels will produce very large bonuses, while poor performance will result in substantially reduced award levels. For example, if the plan has two goals in which each goal achieves a 150-percent payout, the final award would be 225 percent of target payout. Conversely, if performance against each goal produced a 75-percent payout, the total payout would be 56 percent.

One disadvantage to this type of plan is its high leverage may not be viewed favorably by some investors, given the troubled economic environment. Another disadvantage is that weighting individual goals under this design often leads to internal confusion and disputes with executives over how final award levels were calculated. To illustrate, assume that in the example above, Goal 1 had

a 50-percent weight, Goal 2 a 30-percent weight and Goal 3 a 20-percent weight. Under this complex weighting, the final award would be 105 percent of target — $(1.2 \times 0.5) + (1.0 \times 0.3) + (0.75 \times 0.2) = 1.05$, or 105 percent — a result that is far from intuitive.

This type of plan can be highly effective where it is critical that a company achieve a threshold level of performance for all goals. An example would be a company that is trailing its peers in both revenue and profit growth, a situation in which a multiplicative design is likely to be more appropriate and effective.

Tips for Making Multiplicative Designs Work

- Include a maximum of three financial performance measures.
- Include an operational or administrative goal only if performance can be easily measureable.
- Exclude strategic or individual goals, where performance is harder to assess.
- Remind participants on a regular basis over the performance period — especially if the company is not expected to meet target performance — that missing threshold performance on even one goal will eliminate bonuses.

Simplicity Test: Passed, as long as the weighting of goals is kept simple.

No compensation program can work effectively — in any economy — if it is not clearly understood by all participants. In multiplicative plans, the level of potential awards is less obvious, especially in comparison to overall performance, and the formula tends to become even more confusing if weightings are introduced.

Discretionary Designs

Executive incentive plans rarely permit full discretion on payouts. However, introducing an element of judgment for the group of executives whose awards are directly reviewed by the

compensation committee (which at midsize to large companies would be the most senior level of management) can enhance the effectiveness of a performance-based plan. Based on more subjective considerations, the directors may decide to increase or reduce payouts for some elements of performance or a portion of awards (e.g., 20 percent to 30 percent). This approach is useful in assessing performance against strategic goals that may be more difficult to measure quantitatively, or when establishing precise goals is difficult.

Discretionary plans can be highly effective for companies going through a major transition. For example, if a struggling company hires a new CEO as it is setting goals for the next year's incentive plans, the CEO may not have had an opportunity to fully evaluate the changes needed. Allowing an element of discretion may give the CEO needed flexibility to reward executives, without being fully locked into goals that may turn out not to be optimal.

Tips for Making Discretionary Plans Work

Allowing room for discretion raises issues that must be addressed before the plan is implemented. For example, the compensation committee must analyze whether employing discretion might have an impact on compliance with Section 162(m), which prohibits the deductibility of any nonperformance-based pay in excess of \$1 million for proxy-disclosed executives. Under Section 162(m), awards can only be adjusted downward, not increased. The company must consider this requirement in any discretionary design. The committee also should consider up front how a discretionary program would be disclosed in the compensation discussion and analysis section of the

proxy statement. The disclosure should make a convincing case to shareholders as to how the introduction of discretion to the plan will strengthen the connection between executive pay and performance. Companies also should be mindful that using discretion, more so than with formulaic plans, requires a strong working relationship between management and the compensation committee. Both sides must agree, at the beginning and end of the performance period, on the discretionary factors to be considered in assessing performance, lest management feel blindsided by the approach ultimately taken in determining bonus awards.

Simplicity Test: Depends on implementation. Only if the overall desired performance objectives are well documented, and clearly understood by members of the committee and management, does the plan pass the simplicity test.

Combination Designs

Some incentive programs combine one or more of the concepts outlined above. For example, an additive plan might permit some level of discretion in determining the level of performance goals or the resulting payouts, thereby introducing an element of flexibility without unduly increasing design complexity.

Combination plans typically incorporate specific funding triggers, or plan conditions, that must be met before any award is provided. For example, a plan may require that the executive meet threshold profitability regardless of achievement against other plan goals. Funding triggers are considered a best practice by many, although they are more challenging to define in a volatile business environment. Generally, funding triggers should be extensively modeled before adoption to ensure that in best-case/worst-case

scenarios and final award levels are appropriate and reasonable. An overly aggressive funding trigger may result in zero bonus, even if the company had a good year based on other performance measures. Alternatively, a weak trigger may be criticized by investors as having little impact on final performance.

Combination plans that include funding triggers can be usefully employed in relatively stable businesses or industries. For example, a profit trigger might make sense if a company can demonstrate that its profits historically have fallen within a fairly predictable range.

Tips for Making Combination Plans Work

- Although performance triggers are sometimes cited as a best practice, it is critical that participants realize that missing the trigger will result in no bonuses.
- If discretion is introduced, participants should understand when discretion will be taken into account and how it might affect bonus payouts.
- Combination designs are generally not appropriate for volatile businesses and industries, unless the potential outcomes are extensively modeled.

Simplicity Test: Failed. However, even designs that incorporate many moving pieces can be used effectively to focus an executive on specific objectives without becoming impossibly complicated. An example would be a combination design structured around just two performance metrics and one funding trigger. On the other hand, a plan that incorporates four performance metrics and two funding triggers would be a bad design under almost any circumstance, since managers may regard the goals as not being achievable under any circumstances.

When Complexity is Warranted

After thoroughly analyzing the alternatives, you may conclude that a more


complex design offers specific benefits to your firm that outweigh the potential pitfalls. For example, a company with several unrelated lines of business might prefer having multiple plans in place that have different performance measures and different plan designs. Even in such a case, however, generally a company will want the plan to keep everyone focused on one priority, such as profitability. In such a case, all the plans might heavily weight profitability against the other performance measures used in the plans.

If you opt for more complexity, keep in mind two critical design needs:

Model, model, model. For simple designs, modeling three or four economic scenarios is usually sufficient. For complex designs, it is advisable to double the number of scenarios to avoid unintended consequences and surprises down the road. Typically, modeling would take into account multiple factors including financial projections, acquisitions, divestitures, headcount changes and pending legislation that could materially affect the business.

Communicate, communicate, communicate. A one-page outline of a simple plan design is usually sufficient to explain its workings, but is totally inadequate for a more complex design. Companies should plan for more extensive communication to participants that includes a detailed description of the new plan and specific examples of how awards will be calculated. Additionally, ongoing communication in regard to incentive plan funding will be needed, since funding status tends to be less clear for plans with three, four or more performance measures. Companies can develop a web-based program to communicate the program, which can be a highly cost-effective means of ensuring that all employees get the same information.

Conclusion

When you are ready to consider changes in your annual incentive programs, keep in mind that relatively simple plan designs are inherently easier to communicate and generally provide more predictable awards for a given level of performance. While complying with the requirements for annual proxy disclosure of incentive programs is never easy, the process will go significantly more smoothly for a straightforward program design. Everyone benefits by better proxy disclosure because well-designed programs that are clearly communicated are more likely to be understood and supported by all constituencies, from individual shareholders and institutional investors to governance experts and participants themselves. 

ABOUT THE AUTHOR

Peter A. Lupo is managing director and head of the New York office of Pearl Meyer & Partners. He can be reached at peter.lupo@pearlmeyer.com or 212-407-9509.

RESOURCES PLUS

For more information related to this article:

www.worldatwork.org

Type in any or all of the following keywords or phrases on the search line:

- Incentive pay
- Incentive plan design
- "Pay+communication."

www.worldatwork.org/bookstore

- *Incentive Pay — Creating a Competitive Advantage*
- *Cash Bonuses — Four Ways to Attract, Retain and Motivate Employees, Second Edition*
- *Designing Management Incentive Plans: How-to Series for the HR Professional.*

www.worldatwork.org/education

- Variable Pay — Improving Performance with Variable Pay Certification Course: C12
- Determining Pay For Executives (Competitive Market Pay) Seminar
- Pricing Sales Positions (Competitive Market Pay) Seminar.