PAY FOR PERFORMANCE

Incentive Design for Compensation Committee Members

Board members bring a wealth of talent and experience to the companies they serve, but often have no practical exposure to the basic building blocks of effective compensation design. Before committee members jump into aligning incentives with company strategy, discussing best practices, or considering accounting and tax implications, it can be very beneficial to review the concepts typically used by compensation professionals in incentive design. In our experience over the past 30 years, we have seen countless successes and failures of incentive arrangements. As our experiences accumulated, we found that a distinct pattern emerged, which we have long since distilled into the four pillars shared below.

In general, the most successful incentive plans strike a balance between these four pillars that support the entire incentive design structure. The plans work when participants exhibit the following:

1. Know what is expected of them

If the performance metrics are not a "household word," do not tie pay to them. Companies and boards often get excited about new concepts and measurements that drive organizational value, but if those measures are not part of the 24/7 fabric of the participant's work life, the plan likely won't work. Thus transitioning to new concepts requires training and retraining until the concepts sink in, before tying pay to the measures. As we develop and select new measures to better reflect execution of company strategy, the trick is ensuring that each measure is understood and embraced, much like the overall strategy.

2. Believe it is achievable

Oftentimes companies place unrealistic targets in front of participants (e.g., $4.00 EPS when $2.50 is the rolled-up budget). There has to be a degree of buy-in to the goals or the plan will be ignored or at the very least ineffective. Many firms have moved away from such top-down goal setting, but several still use this approach and their incentives do not incent. If you want to reward for a 16% ROIC and the enterprise is currently only generating 12%, a road map showing how the goal can be achieved is mandatory.

3. Track progress during the performance measurement cycle

Participants need to see the goal line regularly. During the performance measurement period, tracking performance (perhaps monthly for an annual goal) is crucial to plan effectiveness. Modern enterprise data solutions make this issue fairly moot in most cases, but newer goal concepts at many firms have resulted in performance-tracking lag times that render plans ineffective. For example, not seeing the results versus goal for Q1 until the end of Q2 is not highly motivational for annual plan participants. If the metric is important enough to be rewarded, it is important enough to be part of timely, transparent communication.

4. Earn a meaningful amount for achieving the goal

In most executive pay plans, this is also a moot issue as long as there are regularly set competitive target bonus opportunities, but some firms don't set such targets. Also, in certain industries, the bonus plans often roll down to lower levels in the firms. Experience has taught us that at least one month of pay (e.g., 8% of base salary) is the minimum target opportunity for the lowest level. At executive levels, we seldom see targets below 30% of annual salary. Participants are incented by pay amounts that can make a difference in their lives. Working hard to achieve goals yet earning merely enough to take one's spouse to dinner after a long year is probably not a meaningful amount.

The Take Away

Compensation committees are responsible for bringing the company's strategy into focus through the use of incentives. In addition to the other critical elements involved in addressing compensation matters, members are advised to keep in mind these four simple pillars to ensure the resulting incentive design is effective.

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