Getting It Right—Paying for Performance Through Variable Pay

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Variable pay has become the primary mechanism to pay for performance today.

There are sub-optimal practices that are inhibiting the effectiveness of variable pay plans.

Now is the time to **Get it Right!**
Road Map for Today’s Discussion

- Variable Pay’s Role in Pay for Performance Today
- Learning From Our Mistakes
- Getting it Right: Criteria and Tools
- Your Questions!
Sources of Information

- Variable Compensation Measurement™
  - Broad-based plans
  - Created in 1996
    - More than 380 cash variable pay plans
    - 300 companies
    - 1.9M employees
  - Plan characteristic driven database
    - Prevalence
    - Effectiveness

- Hewitt Salary Increase Survey
  - Created in 1976
  - Fortune 1000 companies
  - 1,156 companies in 2009
  - Merit/overall salary increases
  - Salary structure movement
  - Variable compensation
  - Special topics
Variable Pay’s Role in Pay for Performance Today
Use of Variable Pay

Percent of Companies With a Variable Pay Plan

Participation in Variable Compensation

Prevalence in Variable Pay Plans By Employee Group

10 Years Ago
- Salaried Exempt: 74%
- Salaried Nonexempt: 41%

Today
- Salaried Exempt: 81%
- Salaried Nonexempt: 52%

Increasing Line of Sight

Focus of Variable Pay Plans Based on Plan Type

- **Individual Performance Plans**
- **Business Incentives**
- **Cash Profit Sharing**
- **Gainsharing**

Growing Role of Individual Performance

Inclusion of Individual Performance in Variable Pay Metrics

17% 10 Years Ago

36% Today

Budgeted Spending: Base Salary Increases in Decline

Budgeted Spending: Variable Compensation on the Rise

Projecting Future Budgeting

Percent of Payroll

<table>
<thead>
<tr>
<th></th>
<th>Today</th>
<th>10 Years From Now</th>
</tr>
</thead>
<tbody>
<tr>
<td>Base Salary Increase</td>
<td>2.5%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Variable Pay Budget</td>
<td>11.8%</td>
<td>16.0%</td>
</tr>
</tbody>
</table>

Source: Hewitt Salary Increase Survey 2009–2010
Focus on Total Cash to Attract/Retain Talent
Variable Pay Has Become a Global Phenomenon

Why the Dramatic Shift to Variable Pay

- Fixed vs. variable costs
- Need to focus and drive behaviors
- Need to create alignment
- Perceived control
- Shareholders/analysts value it
Learning From Our Mistakes
### Plan Weights

<table>
<thead>
<tr>
<th>Corporate</th>
<th>50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Income</td>
<td>25%</td>
</tr>
<tr>
<td>Revenue</td>
<td>25%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Business Unit</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash Flow</td>
<td>10%</td>
</tr>
<tr>
<td>Revenue</td>
<td>5%</td>
</tr>
<tr>
<td>Quality</td>
<td>2.5%</td>
</tr>
<tr>
<td>On-Time Delivery</td>
<td>2.5%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Department</th>
<th>20%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Safety</td>
<td>10%</td>
</tr>
<tr>
<td>Attendance</td>
<td>10%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Individual</th>
<th>10%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Attendance</td>
<td>2%</td>
</tr>
<tr>
<td>Project Completion</td>
<td>3%</td>
</tr>
<tr>
<td>Idea Creation</td>
<td>5%</td>
</tr>
</tbody>
</table>

**100%**  
**$2,500**

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Learning From Our Mistakes
Learning From Our Mistakes

<table>
<thead>
<tr>
<th></th>
<th>Salary Increases</th>
<th>Annual Bonus</th>
<th>Special Recognition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Executives</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Directors</td>
<td>X</td>
<td>X</td>
<td></td>
</tr>
<tr>
<td>Managers</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>High-Level Exempt</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Other Exempt</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
<tr>
<td>Nonexempt</td>
<td>X</td>
<td></td>
<td>X</td>
</tr>
</tbody>
</table>
Learning From Our Mistakes

- **Maximum**
- **Target**
- **Threshold**

Funding Levels:
- $1.0M
- $1.5M
- $3.0M
- $6.5M

Legend:
- **Funding Required by Plan**
- **Actual Available Funding**

Funding Gap
Learning From Our Mistakes

- Corporate Results
- Business Unit Results
- Department Results
- Individual Results

Non-exempts   Entry Exempts   Managers   Directors   Executives

X   X   X   X   X   X

X
Learning From Our Mistakes

Distribution of Total Payout as % of Target

# of Incumbents

Total Payout as % of Target

Company Perf as % of Goal
Learning From Our Mistakes

Business Performance

Bonus Payout
Learning From Our Mistakes

Percent of Goal vs Percent of Total Target Incentive

R\(^2\) = 0.1331
Learning From Our Mistakes

Salary to Midpoint Comparison

Bonus Payout Calculation

Employee Salary

$5,000

Grade Midpoint

Calculated Bonus Payment

$10,000

Less Salary Over Midpoint

$5,000

Actual Bonus Paid

$5,000

Salaries

Less Salary Over Midpoint

Actual Bonus Paid

$10,000

$5,000

$5,000
Learning From Our Mistakes

Participation Requirements
No formal requirements to participate

Communication
Year-end pay statement left on desk

Plan Administration
Payout 5 months after close of year
Create focus on required results

Motivate desirable behaviors

Facilitate ideas and improvements

Share in successes and failures

Improve performance

The Role of Variable Pay
Getting it Right: Criteria and Tools
Getting It Right!

- It has never been more critical to get variable pay right
  - Role in pay for performance
  - Increasing investments
  - Management expectations
  - External scrutiny
Getting It Right: Diagnosis and Ongoing Plan Validation

- **Alignment**
  - Common goals with clear linkages
  - Controllable
  - Relevant to the Business
  - As few as possible

- **Measures**
  - As much direct influence on outcomes as possible

- **Line of Sight**
  - Accrued
  - Reflective of actual results
  - Increasing

- **Funding**
  - Be as inclusive as possible

- **Eligibility**
  - Competitive
  - Appropriate pay at risk given line of sight and role

- **Targets**
  - Minimal performance standards

- **Participation Requirements**
  - Reflective of pay philosophy and culture
  - Balanced between realistic and challenging

- **Plan Mechanics**
  - Understandable and communicated goals
  - Goals shared before plan starts
  - Progress reports

- **Communication**
  - Not overly burdensome
  - Should include assessment of continuous improvement

- **Plan Administration**
Getting it Right: Performance Measures

Problem
- The current STI was not effectively rewarding for business and individual performance

Before Program Redesign
- Eligibility limited to Directors and above
- Program only paid for corporate results—no consideration for Business Unit performance
- Individual component (10% of base) was not aligned to an appropriate target, ill defined, subjective, and traditionally always paid
  - Company’s recommendation was to have 4 to 5 measures weighted at 2.5% to 2%
Getting it Right: Performance Measures

Many alternative design approaches and performance measures considered

**Award Pools**
(Funding = % of Profit)

- Participant A
- Participant B
- Participant C
- Participant D

**Additive Opportunities**
(Funding = Sum of Required Payments)

\[
\text{Earned Award} = \text{Measure A} + \text{Measure B} + \text{Measure C}
\]

**Multiplicative Models**
(Funding = Sum of Required Payments)

\[
\text{Earned Award} = \text{Measure A} \times \text{Measure B} \times \text{Measure C}
\]

**Modifiers**
(Funding = Sum of Required Payments)

\[
\text{Earned Award} = \text{Measure A} \times \text{Measure B} \times \text{Measure C}
\]

**Discretionary Plans**
(No Specific Funding Mechanism)

**Hybrids**
(Funding = Sum of Required Payments Modified by Pool Size)

\[
\text{Earned Award} = \text{Measure A} + \text{Measure B} + \text{Measure C}
\]
Getting it Right: Performance Measures

- Recommendations
  - Expanded plan eligibility deeper in the organization (all exempt employees)
  - Aligned the incentive plan and employees to the business goals

<table>
<thead>
<tr>
<th>Job Level</th>
<th>Incentive Target</th>
<th>Incentive Weighting</th>
<th>Individual Modifier</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Corporate</td>
<td>Business Unit</td>
</tr>
<tr>
<td>Executives/Sr. Vice Presidents</td>
<td>40%</td>
<td>100%</td>
<td>N/A</td>
</tr>
<tr>
<td>Vice Presidents</td>
<td>30%</td>
<td>70%</td>
<td>30%</td>
</tr>
<tr>
<td>Directors</td>
<td>20%</td>
<td>50%</td>
<td>50%</td>
</tr>
<tr>
<td>Managers</td>
<td>10%</td>
<td>40%</td>
<td>60%</td>
</tr>
<tr>
<td>Professionals/Specialty Roles</td>
<td>5%</td>
<td>30%</td>
<td>70%</td>
</tr>
</tbody>
</table>
## Diagnosis and Ongoing Plan Validation: How One Plan Measured Up

<table>
<thead>
<tr>
<th>Category</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Measures</strong></td>
<td>- Corporate, 50%</td>
</tr>
<tr>
<td></td>
<td>- Individual, 50%</td>
</tr>
<tr>
<td></td>
<td>- Performance measured at Corporate and individual levels</td>
</tr>
<tr>
<td></td>
<td>- Measures aligned with Plan Objectives</td>
</tr>
<tr>
<td><strong>Eligibility</strong></td>
<td>- Exempt Employees &gt;$60,000 – 85%</td>
</tr>
<tr>
<td></td>
<td>- Exempt Employees &lt;$60,000 – 78%</td>
</tr>
<tr>
<td><strong>Funding</strong></td>
<td>- Performance trigger</td>
</tr>
<tr>
<td></td>
<td>- High eligibility and high spend</td>
</tr>
<tr>
<td><strong>Alignment</strong></td>
<td>- Consistency in the pay out of awards across all employee levels</td>
</tr>
<tr>
<td></td>
<td>- Common measure or measures across all eligible employee groups</td>
</tr>
<tr>
<td><strong>Line of Sight</strong></td>
<td>- Primary focus on Corporate Measure</td>
</tr>
<tr>
<td></td>
<td>- Measures are balanced across all levels (i.e., not too much on Corporate)</td>
</tr>
<tr>
<td><strong>Plan Mechanics</strong></td>
<td>- Relationship between amount of stretch in goal setting and formula parameters is reasonable</td>
</tr>
<tr>
<td></td>
<td>- Pay out is below target if objectives are not met</td>
</tr>
<tr>
<td></td>
<td>- Thresholds and maximums are reasonable</td>
</tr>
<tr>
<td></td>
<td>- Pay outs for key contributors relative to average is 175%</td>
</tr>
<tr>
<td><strong>Targets</strong></td>
<td>- Pay out targets +/- 10% to 15% of market targets</td>
</tr>
<tr>
<td></td>
<td>- Degree of stretch built into performance target: moderately low stretch</td>
</tr>
<tr>
<td><strong>Participation Requirements</strong></td>
<td>- Gate for individual performance</td>
</tr>
<tr>
<td></td>
<td>- Part-time employees are eligible</td>
</tr>
<tr>
<td></td>
<td>- Must be employed on the last day of the measurement period</td>
</tr>
<tr>
<td><strong>Communications</strong></td>
<td>- Direct and indirect</td>
</tr>
<tr>
<td></td>
<td>- Only payout targets and maximum are communicated</td>
</tr>
<tr>
<td></td>
<td>- Frequency: Quarterly</td>
</tr>
<tr>
<td><strong>Plan Administration</strong></td>
<td>- No process in place to evaluate the plan</td>
</tr>
<tr>
<td></td>
<td>- Takes 24 person weeks to administer</td>
</tr>
</tbody>
</table>
# Incentive Plan Scorecard: How One Plan Measured Up

<table>
<thead>
<tr>
<th>Variable Pay Index™ Scorecard</th>
<th>Effective Zone</th>
<th>Score</th>
<th>Maximum Score</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Overall Score</strong></td>
<td></td>
<td>696</td>
<td>1,000</td>
</tr>
<tr>
<td>1. Measures</td>
<td>Effective Zone</td>
<td>100</td>
<td>150</td>
</tr>
<tr>
<td>2. Eligibility</td>
<td>Highly Effective Zone</td>
<td>75</td>
<td>100</td>
</tr>
<tr>
<td>3. Funding</td>
<td>Highly Effective Zone</td>
<td>75</td>
<td>100</td>
</tr>
<tr>
<td>4. Alignment</td>
<td>Highly Effective Zone</td>
<td>75</td>
<td>100</td>
</tr>
<tr>
<td>5. Line of Sight</td>
<td>Effective Zone</td>
<td>50</td>
<td>100</td>
</tr>
<tr>
<td>6. Plan Mechanics</td>
<td>Effective Zone</td>
<td>62.5</td>
<td>100</td>
</tr>
<tr>
<td>7. Targets</td>
<td>Highly Effective Zone</td>
<td>75</td>
<td>100</td>
</tr>
<tr>
<td>8. Participation Requirements</td>
<td>Highly Effective Zone</td>
<td>100</td>
<td>100</td>
</tr>
<tr>
<td>9. Communication</td>
<td>Highly Effective Zone</td>
<td>83.5</td>
<td>100</td>
</tr>
<tr>
<td>10. Plan Administration</td>
<td>Ineffective Zone</td>
<td>0</td>
<td>50</td>
</tr>
</tbody>
</table>
Diagnosis and Ongoing Plan Validation

VPI™ Scorecard

Highly Effective Zone  
Effective Zone  
Partially Effective Zone  
Ineffective Zone

- Measures
- Eligibility
- Funding
- Alignment
- Line of Sight
- Plan Mechanics
- Targets
- Participation Requirements
- Communication
- Plan Administration
Incentive Plan Scorecard

The analysis details each design characteristic through “speedometers” that compares to both best practice, our normative VCM Database, or a selected peer group.

Overall Score

XYZ Company

Ineffective Zone
Partially Effective Zone
Effective Zone
Highly Effective Zone
Company’s Score

0–249
250–499
500–749
750–1000
696

0
1000

Partially Effective Zone
Effective Zone
Ineffective Zone
Highly Effective Zone
Getting It Right: Answering Critical Questions…

How does our annual incentive plan compare to best practices?

How can we change our annual incentive plan to make it more effective?

How can we demonstrate to our leaders how our plan supports business objectives?

How does our annual incentive plan compare to those in my industry?

What characteristics have the greatest impact on plan effectiveness?
Your Questions
Your Presenter(s)

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