Aligning Incentive Plans **to Business Goals Post COVID**

NOV • 17 • 2020

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Reprint from Chicago SHRM, October 2020

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Search and Compensation Consulting

Much has been published regarding how work has changed due to COVID. Digitalization applications have increased since COVID was declared a pandemic in March 2020. Many employees suddenly worked from home and many continue to do so. Some companies have reduced workforces both temporarily and permanently. The criticality of innovation and speed to market has increased, and workforces have become more flexible.

A new world of work remains as COVID continues to shake up organizations world-wide. The new world of work is bringing many changes to jobs: job content, communication channels across jobs, supervisory span of control of jobs, rapidly evolving jobs, work processes and more.

An effective incentive plan is essential to support the achievement of changing business goals. Fall 2019 when leaders were designing 2020 incentive plans, they had no idea how the world of work would change. This article summarizes research from multiple sources as well as provides direction and considerations as incentive planning gets underway for 2021.

Everything Starts with Job Content

=> Implement the Right Plan for the Right Situation

In order to design an incentive plan, the current purpose of a participant's job must be examined along with how each job contributes to the organization's bottom line. During COVID, processes were forced to change given the shut-down of many physical sites and switch to working remotely. Without this simple yet sometimes overlooked review of a job's content, participants in an incentive plan will not maximize individual performance and its linkage to drive business results. A direct linkage between a job and the incentive plan must align to business results and participants must have control to achieve and exceed business goals. Without such linkage, motivation for the right behaviors will not exist and therefore an incentive plan will not return the greatest bang for the buck.[1]

Subjective Goals are Making a Comeback

=> Plan Metrics Matter More than Ever

Most organizations review incentive plans on an annual basis to ensure a plan drives the right behaviors. This is a prudent step because organizations are constantly evolving like a living organism. Understanding where an organization is within its lifecycle is critical to align with the setting of achievable goals, having the right participants in the plan, and including metrics that make sense for the organization's unique situation. Without achievable goals, the right participants, and the right metrics, participants will not be motivated to perform to the maximum potential and the plan could under or overpay participants.

One of the metrics of incentive plans that is getting a lot of attention during COVID is the use of discretion. Discretion is a metric whereby decision-makers can choose to add positive discretion and increase payouts from what the actual results would have paid out. Similarly, negative discretion reduces a payout from what the actual results would have paid out.

Research shows the use of discretion increasing as a result of COVID. For example, one study, Pearl Meyer & Partners, LLC, found that 22% of participants who made changes to their incentive plans due to COVID introduced discretion language into their short-term incentive plans[2]. Another study conducted by Semler Brossy Consulting Group found that 23% of participants added discretion to their annual incentive plans either for the current 2020 plans or go forward 2021 plans.[3]

The use of discretion is frowned upon by some shareholders and most institutional shareholder groups and has been viewed with more concern since the increased focus on paying for financial results, and not merely paying for activity or effort. Adding discretion to modify actual payouts is a slippery slope that puts unnecessary pressure on decision-makers to modify payouts. Executive incentive plans are particularly impacted because decision-makers want to retain the incumbents who likely have the majority of their compensation pay mix at risk in the form of variable pay versus guaranteed salary.

Some participants have come to expect a payout every year while a rule of thumb is that incentive plans pay out at target every three to five years in an organization. However, when all companies who participate in high-quality third party published surveys, it seems as if companies consistently payout close to their targets holistically. Each industry has its ebbs and flows greatly influenced by both external and internal factors. Because of this, many organizations have added relative performance measures to long-term incentive plans. According to FW Cook & Partners, LLC, 59% of publicly traded participants in a study used total shareholder return as a long-term measure and require the payout to be based relative to peer, and not absolute, performance.[4]

Moving with Flexibility and Speed

=> Plans Are Likely to Change More Frequently

Research has demonstrated that consumer buying channels are changing and accelerating due to COVID[5]. In turn, new channels are forcing some jobs' content to change in order to satisfy consumers' changing buying patterns. As a result, more team-based assignments may occur with rotations to other projects than in the past. Dealing with multiple roles and projects will making it challenging to determine a traditional annual incentive plan's design, measure(s), and payout calculation. Therefore, we can expect the need for more frequent payouts of incentive plans to become more common versus the traditional annual incentive plan. For example, WorldatWork found that 86% of privately held companies use an annual incentive program versus other type of variable pay program.[6] Historically, project or short-term bonuses are used in the IT or Research functions when focus on delivering results for a specific application or product are critical to the success of the organization.

Project-based pay aligns a team's behavior holistically and can effectively deliver results of a successful project on time and under budget. In order to keep performance tied to results, a plan participant should be rewarded for his or her contributions for each separate project. The most powerful reward should be paid out at the conclusion of the project and that lends itself to the expectation of mid-year, and multiple, potentially quarterly, or ad hoc timing of when an incentive plan will pay out. Setting goals up front at the beginning of each short-term project promotes more specific communication, structure and definition of expectations that may not otherwise exist in a traditional annual incentive plan whose goals are typically set at the beginning of the change and do not change mid-year.

Bottom Line Business Sustainability

=> Affordability

COVID has caused some industries to take a serious look at controlling costs. A study by the Conference Board found that accelerating cost management and budget reductions are one of the top five most important long-term impacts to the company due to COVID[7]. Organizations can be prudent in considering the adjustment of some levers in order to financially protect the organization from overpaying an incentive plan during this volatile period among impacted industries. First, an organization may want to review who is participating in the plan. Reducing plan participants is a simple way to reduce potential cost. Most legal plan documents and employee communications state, and if not, should state, that management reviews and selects the participants in the plan annually. Stating this fact tempers the expectations of employees albeit it is a drastic change to implement.

Second, examining the plan's[LV1] threshold, target and maximum payouts allow for a less obvious plan modification than outright removing participants from the plan. By reducing a payout maximum as a percent of salary, such as from 250% to 150% can curb excessive payouts. Participants will likely notice such a change, but if communicated effectively, plan participants should respect that an organization does not have a bottomless checkbook especially in the era of COVID. Similarly, by raising the payout threshold percentage, for example, from 60% to 80%, is another effective method to modify the plan while still keeping it motivational. By increasing the target performance required for a target payout is another method commonly used to provide some level of "plug" in the financial formulas ensuring the organization will have enough profit dollars to afford the payout.

Third, adjusting a plan's target percent or dollar payout downward at the participant level is another metric used albeit less frequently. If a plan does not use, or partially uses, financial goals, this may be a good time to explore any qualitative measures in the plan's design. Are they created with an appropriate level of stretch so that a payout is not guaranteed. If the goals are non-quantitative, an organization should review if the goal's achievement directly impacts the bottom line, or whether it is rewarding activity and effort that do not contribute to the bottom line.

For years to come after COVID, we can expect increased analysis and modification of incentive plans as we adjust to our new world of work. Reviewing plans more frequently and with prudence ensures a more favorable and sustainable business position.

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Biographies

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