Developing Performance Incentives and Sustaining Engagement in a Volatile Environment

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A Joint Research Initiative between PARC and WorldatWork

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A. Foreword: what’s on offer?

Over the last three years, the role of incentives has had greater public prominence than ever before. This was probably inevitable given the perceived relationships between incentive practice in the banking sector, the financial crisis and the regulatory actions that followed.

The popular media now take a much stronger interest. In the UK, the US and no doubt elsewhere, variable pay outcomes have become significant news events. The terms “bonus” and “incentive” have become tarnished. The traditional aims of incentives – to provide motivation, focus and variable cost – often seem to have been undermined. The public focus is on executive incentive plans as being “bonuses” although such plans are now an ingrained part of the reward program for employees at all levels in commercial organizations.

In parallel with this, the economic environment has of course been very difficult; many companies have seen demand for their products and services severely impacted by the recession. While adjusting and trimming their organizations, they have needed to keep their employees engaged and focused. Additionally, a volatile or turbulent context may also be the result of natural events, e.g. volcanic ash or a corporate calamity.

Developing and operating incentive plans in such circumstances has not been easy. Decisions which take account of several perspectives need to be taken to ensure that incentives continue to operate in an appropriate way.

This report offers:

- a reminder of how incentives have developed
- a summary of current thinking on how incentives influence engagement and motivation
- an update on the changes made to incentives by a selection of organizations as they faced the recent recessionary environment
- interpretations of these developments, and
- observations and concluding questions.
B. Executive summary: what’s the story?

(i) Incentives are now commonplace and a key part of pay in the private sector. It is through incentives that executives have the opportunity to generate personal wealth. They are also increasingly important for other employees to fund essential major purchases. Measures have changed and become broader for many short-term incentives (STIs). Measures generally remain more narrow or have not been present in long-term incentives (LTIs). Various factors shape the design of incentives, including business strategy, market competitiveness, pay for performance, governance best practice, affordability and motivation/engagement.

(ii) We review the principal theories of motivation and the findings on engagement. These indicate that, in general, incentives are not the primary driver of motivation/engagement. The influence of reward may vary with the type of employee and the organizational setting. On balance however, incentives do reinforce and support performance via communications and enhanced focus – and poorly functioning incentives can demotivate or disengage. Incentives have become a supporting element of the wider performance management system in many organizations.

(iii) There has been considerable change to incentives over the last two to three years. Nearly one third of the companies we spoke to had made changes driven by the recession. Some of these involved discretionary ‘workarounds’; others changed measures so the plan continued to be relevant and challenging but fair. Half our respondents had made changes for reasons other than the recession. Some were to improve risk management, some also to update plan measures, and others to introduce an individual performance element. Together, over three-quarters of companies had made significant alterations to their plans. The main emerging trend is towards using an increased number of measures.

(iv) Several of our respondents were badly hit by the recession and, for some of these, a key factor in their changes was ensuring the continued motivation and engagement of their people. Especially in volatile situations there can be tensions between supporting engagement/motivation and a narrow focus on overall profitability.

(v) The justification for incentive payments has to be financial: they must generate a return greater than their cost. The linkage need not be instantaneous but can be longer-term. Short-term incentives may legitimately include non-financial aspects of performance and also the making of payments that maintain engagement and motivation and so contribute to the longer term.

Getting the nature and balance of targets right for the organization, the challenges it faces and the different types of plan participants is important. We suggest two additional ways of thinking about this balance for STIs: a dimension relating to how the plan operates: from ‘if then’ incentives to ‘now that’ rewards, and a second dimension considering what is rewarded: from ‘pay for performance’ to ‘perceived fairness’.

We conclude that well designed and effectively implemented STIs can do a good job in supporting both performance and engagement. However, it is less clear that long-term incentives currently do this and additional work is probably needed here.
In the UK, just 30 years ago bonuses were very rare. Less than 10% of companies used them on a routine basis. Long-term incentives such as share options and performance share plans had yet to make their appearance. The main elements of reward were salary and pension. If you did a good job, there might be a pat on the back, but there was no bonus – though there may have been an improved chance of promotion (which still seems one of the best forms of recognition and reward).

“Performance-related pay was in its infancy in the early 80s: the typical executive would not expect to earn much, if anything, in bonus awards and share incentives were a rarity. In 1980, Barclays’ highest paid director took home a total of £67,500 while the Chairman (CEO) made £81,000.” Note: UK average earnings in 1980 were £5,700. – Peter Newhouse, Daily Telegraph Executive Pay Report, 16 May 2010.

As the UK moved into the 1990s, ten years later, annual bonus plans were in place at virtually all listed and private companies – not only for the executives but increasingly being introduced lower down the organization. Executive options and employee share plans started making their mark as new elements of the package.

In the US, prevalence trends were in advance of those in the UK and the levels of executive bonus and stock options were usually more generous. US firms started to extend incentives to employees in their foreign subsidiaries and encourage a global trend.

New types of long-term plans were subsequently introduced for executives in UK owned companies, often called LTIPs or performance share plans. Like bonuses and options they were typically added to the existing package.
As executive rewards grew on both sides of the Atlantic, and following requirements for greater disclosure, pay data become more widely available. Awareness of the scale of reward for the most senior executives grew and public debate about executive pay took off.

Into the 2000s and variable pay incentives were increasingly common in both the US and the UK. Charts 1 and 2 illustrate developments in the US. Chart 1 shows the growth in the proportion of organizations offering some form of variable pay below the executive level (now 80%). Chart 2 shows the increase in the proportion of non-unionised junior staff eligible for variable pay (which is even higher at 90% given the variable pay practices of larger employers). Chart 3 illustrates developments in the UK and shows changes in the value of bonus payments in the economy as a whole.

(percentage of organizations using some form of variable pay below Officer and Executive level)


Source: WorldatWork Annual Salary Budget Surveys

Source: WorldatWork Annual Salary Budget Surveys
Executive packages, particularly incentives, continued to rise well above inflation. Chart 4 overleaf illustrates the significant growth in the bonus opportunity of UK FTSE 100 main board directors. However governance pressures also increased, and, on both sides of the Atlantic, the heat around executive remuneration was intensified by high-profile corporate failures where executives appeared to win out financially despite the corporate disasters they had presided over.

(ii) As executive incentives became more and more significant, so differentials have widened considerably between the pay of the most senior executives and the level of average pay within society. In 1980 the Barclays’ CEO (UK) was paid around 14 times average earnings. The CEOs of the UK’s 100 largest companies now earn over 80 times the average pay for full time workers. Differentials in the US are even wider than those in the UK. A key difference between 1980 and now is that, through incentive plans, the opportunity to create personal wealth has been extended to executives. In the past this opportunity was generally restricted to owners.


![Bar chart showing growth in aggregate value of bonus payments: Whole economy vs Financial sector from 2000 to 2009.](Source: Office for National Statistics July 2010)
(iii) A degree of constraint has been evident more recently with the recession leading to base salary freezes and reductions in incentive payouts. Although the operation of incentives in financial services organizations is increasingly regulated to avoid generating inappropriate risk, it is clear that incentives will continue to be a key part of reward packages for employees across the private sector as a whole.

In the UK, 70% of companies froze the base salaries of directors during 2009 and 10% of companies awarded no bonus for 2008. Source: Deloitte

(iv) Although most organizations (and employment contracts in countries that operate them) hold that incentives are discretionary rather than contractual and operate at the will and choice of the organization, participants increasingly and understandably see them as a key part of the package. This is particularly the case with cash bonuses and not just for senior executives on larger packages. For regular employees, the annual bonus may provide key funding for essentials such as vacations, university education for children and, for the far-sighted, perhaps even the retirement pot. Indeed, at the executive level, with the decline of defined benefit pension provision, LTIs are becoming a major source of retirement income.

(v) Incentive measures have also changed. When bonuses were originally introduced the focus tended to be on one or possibly two financial measures akin to profit share. If financial results weren’t good, there was
Over recent years the focus, particularly in STIs, has shifted to comprehend how results have been achieved and whether progress has been made on strategic goals that build the future and make success sustainable. As a result, the incentive mix may comprise 4-6 financial and non-financial measures, some of which may pay out even when business financials are strongly pressed. The measures and their weightings change over time in accordance with business priorities but may also provide a degree of protection from the major swings that may occur when incentives are purely linked to one or two financial measures. There are now fewer zero and fewer maximum bonus payouts, though there is some scope for the exercise of post-hoc judgement in determining an ‘appropriate’ level of overall payout.

Chart 5 shows how the mix of measures used in the STIs of UK FTSE 100 company directors has changed over the last five years.

In the UK, long-term incentives still tend to be driven by one or two shareholder focused financial measures. In the US, although the use of performance plans is growing, restricted stock and option programs rely on time based vesting and the main links to value creation are through the allocation process and the stock price.

With a wider range of incentive measures, the package as a whole has become increasingly complex. In many organizations incentives are operated on a formulaic basis. In other organizations, there may be a stronger element of judgement applied in assessing achieved performance. This may depend on the sector model or on the degree of comfort and trust within the organization or between the organization and its shareholders.

(vi) In any event, determining the mix and balance of measures across incentives is not straightforward. Shareholder concerns about an appropriate relationship with corporate profitability, participant concerns about the degree of volatility of incentives,
and company concerns about costs on the one hand and competitiveness on the other, all have the potential for creating inherent tensions in the operation of incentives.

In developing their incentives, organizations need to take account of business strategy, market competitiveness, pay for performance, affordability, governance factors and motivation/engagement. Combining the right balance in something that will fit their culture is a key challenge.

The next section looks more closely at the motivation and engagement aspect of incentives.
D. Incentives and motivation/engagement: do incentives work?

a) Incentives and motivation

(i) A great deal has been written about motivation. The economists tend to start with the rational man acting out of economic self-interest with money as the primary motivator. The psychologists tend to focus on sources of motivation other than money. In the paragraphs that follow we remind ourselves of the principal theories and how they relate to the design of incentives.

(ii) As we have seen, incentives were initially introduced for top management and underlying this was Agency Theory. This observes that the separation of ownership from control is an important feature of the modern corporation. It creates the need for the principals, i.e. owners, to contract with agents, i.e. managers, to run the business for them. However agents do not always act in the best interests of principals and principals do not have as much information about the business as agents. The costs arising from the principals’ efforts to address these issues are termed ‘agency costs’. The theory proposes that agency costs can be minimised by choosing an efficient, outcome based, contracting scheme (pay arrangement). This links payment of the agents to measures which have a direct impact on the wealth of the principal and this provides an appropriate incentive for agents to act in the best interests of principals (shareholder alignment).

The theory also postulates that contracts which have incentive properties that are desirable from the principal’s point of view tend to have unfavourable risk properties from the perspective of the agents. This is because most results-based measures are not controllable by the agent (in comparison with behaviour or input based measures). So, for an agent to be willing to accept a results-based contract, a compensating differential or risk premium must be paid. Results based contracts are therefore expected to be costly. However they may also be efficient if the positive incentive effect (stronger performance) offsets the greater costs of risk bearing by the agent (higher pay).

The above provides some theoretical backcloth to executive pay and touches on an implicit tension. However it does not fully account for the phenomenal growth of executive pay (which probably has more to do with data availability, globalisation and business consolidation). Nor does it comment on the wider issue of whether incentive plans actually motivate their participants. This is what we turn to now.

(iii) Seasoned professionals will recall Maslow’s Hierarchy of Needs (physiological; safety; social; esteem; self actualisation)
and Hertzberg’s *Motivation – Hygiene Theory* (motivators or growth factors as ‘satisfiers’; hygiene or maintenance factors as ‘dissatisfiers’). These and related theories attempt to identify the things which motivate the individual at work. Readers may recall that salary was characterised as a hygiene factor and a potential dissatisfier.

(iv) If these theories look at what motivates, other theories attempt to identify the process of motivation. *Expectancy Theory* views performance as a joint function of a person’s ability and ‘motivational force’ to achieve something. ‘Motivational force’ is a multiplicative function of:

- expectancy (the perceived link between effort and the expected performance)
- instrumentality (the perceived link between performance and the outcome) and
- valence (the perceived attractiveness of the outcome, e.g. higher pay).

The features of different types of incentive plans can be related to this model. For example, in an organization with a low level of trust, a formulaic system might have higher ‘instrumentality’ than a discretionary system. An individually based incentive plan might have a higher ‘expectancy’ than a group based plan if there is concern that others will not reach their targets.

Various studies have examined expectancy theory. Based on these, Gerhart and Rynes “feel safe in concluding that pay is likely to be a stronger motivator to the extent that (a) people believe they have control over their performance levels, (b) pay is clearly linked to performance, and (c) money is highly valued by those who are doing the performing”.

(v) *Goal Setting Theory* is also highly relevant to the design of incentives. This predicts that:

- higher effort and performance results when people commit to difficult and specific goals rather than to vague commitments
- monetary incentives affect performance to the extent that they influence the choice of goals and commitment to achieving these goals
- commitment to goals interacts with goal difficulty: if goals are set at too high a level or are regarded as impossible, commitment and performance will suffer.

(vi) *Equity Theory* is helpful in understanding dissatisfaction. It focuses on people’s feelings of how fairly they have been treated in comparison with the treatment received by others. People place a weighting on inputs and outcomes according to how they perceive their relative importance. When the ratio of outcomes to inputs equals the perceived ratio of other people’s outcomes to inputs there is equity. Equity is not in itself a motivator. However, where input/output ratios are out of balance, i.e. perceived employee input is high but perceived reward is low, attitudes and behaviour may be negatively affected.

(vii) The debate about financial incentives has
been spurred by the recent publication of “Drive – the Surprising Truth about What Motivates Us” by Daniel Pink. This high-selling book reviews the body of work on motivation and suggests that traditional incentives (particularly “if – then” rewards) “extinguish intrinsic motivation, diminish performance, crush creativity and crowd out good behaviour.” Although such incentives can be effective for boring and routine work where intrinsic motivation is minimal, he believes they are less appropriate for modern creative work especially in new types of organizations. He has a strong preference for unexpected, post-event, reward. This echoes the success of some companies’ spot bonus or non-monetary recognition programs where the power is often in the act of recognition itself.

He concludes that, rather than offering complex systems of reward, “the better strategy is to get compensation right – and then get it out of sight.” His “Zen of Compensation” suggests three ways of doing this:

- ensure internal and external fairness to avoid demotivation
- pay more than average – “a high level of base pay does more to boost performance and organizational commitment than an attractive bonus structure”
- if using performance metrics, make them wide ranging, relevant and hard to game. This helps transform ‘if – then’ rewards into less combustible ‘now that’ rewards which provide feedback and recognition of overall performance.

The motivators that he most strongly supports involve increasing employees’ levels of ‘autonomy’ (control over work), ‘mastery’ (improving abilities) and ‘purpose’ (a worthwhile goal beyond generating profit).

(viii) Pink’s hypothesis that incentives have negative effects seems to focus on incentives that are designed to apply to, and perhaps control, specific roles – rather than the increasingly common programs that relate to the combined work of a team, unit or company using a balanced scorecard. These seem closer to his ‘zen’ model and may be more appropriate for knowledge workers than the type of incentives he is concerned about.

In “Rewards and Intrinsic Motivation – Resolving the Controversy”, Cameron and Pierce conclude that “rewards are not inherently either bad or good for people. Rewards can have negative effects, but such effects are circumscribed, limited and easily prevented.”

This suggests that ‘the trick’ is about getting it right so that it does the job and feels fair – in the case of executive pay, not just to the participants but also of course to the shareholders.

“Rewards can be used to reduce, enhance, or have no effect on measures of intrinsic motivation. Rewards increase motivation and performance on tasks that are of low initial interest. On high interest tasks, positive effects
are obtained when participants are verbally praised for their work and when tangible rewards are offered and explicitly tied to performance standards and success. Producing a negative effect of reward requires a particular combination of circumstances; negative effects are obtained primarily on high-interest tasks when tangible rewards signify failure or are loosely tied to behaviour.” – Cameron and Pierce.

b) Incentives and engagement

(i) Engagement has been defined in various ways and discussion is often unclear as to whether it is attitude, behaviour or outcome. It seems to be all three. Sirota\(^9\) say that there are three components: cognitive (what employees think about their company), affective (what employees feel about their company) and behavioural (how employees act in relation to their company).

Having reviewed various definitions, the recent Corporate Research Forum report “Employee Engagement and Organizational Performance”\(^10\) commented that engagement “is not mere satisfaction, but inspiring employees to align with organizational goals, make discretionary effort, and be an enthusiastic advocate of the organization.”

Engagement is important because, in combination with other factors, it positively impacts productivity, service levels, turnover, absenteeism, and performance. In short, a high level of engagement can provide competitive advantage.

(ii) The drivers of engagement seem to be partly rational but largely emotional. Widely recognized drivers include: care for people, involvement, interesting work, personal development, quality leadership, organizational achievement and integrity, open internal relationships and communication, clear personal expectations and direction, clear performance standards and recognition, and supportive supervision.

(iii) Whilst recognition often features in the list of positive drivers, pay and incentives are usually absent. Money seems to appear pretty low down on such lists, although there are studies which see a positive relationship between employee ownership (through stock/share plans) and engagement.

Top 10 Drivers of Employee Engagement Globally

1. Senior management sincerely interested in employee well-being
2. Improved my skills and capabilities over the last year
3. Organization’s reputation for social responsibility
4. Input into decision making in my department
5. Organization quickly resolves customer concerns
6. Set high personal standards
7. Have excellent career advancement opportunities
8. Enjoy challenging work assignments that broaden skills
9. Good relationship with supervisor
10. Organization encourages innovative thinking.

Source: Towers Perrin\(^11\)
Research also identifies actions (or inactions) which may lead to disengagement. These include low and inconsistent recognition of achievement, inability to deal with poor performance, bad planning and lack of fairness. Ill-fitting pay and incentive schemes can certainly feature in this category, especially when they are perceived to be inequitable in terms of the balance between inputs and outputs. Sirota’s experience from its engagement surveys supports this conclusion. It should be noted that ‘fair and equitable’ does not mean that everyone is paid the same. Although perceptions of “fairness” may be subject to culture and to the framing of the situation, pay according to performance and contribution seems to be increasingly accepted by employees at commercial organizations.

These perspectives on pay and engagement are supported by research findings into high performing organizations. The Center for Organizational Performance in the Netherlands found that no specific reward factor was strong enough to make it into its thirty-five characteristics most prominent in creating a high-performance organization. The perspective on pay systems which had proved to have the highest correlation with high performance was, again, that the system was considered fair by employees.

These perspectives tend to support the view of reward as a hygiene factor – or potential dissatisfier.

Is pay for performance universally recognized as fair?

Much ink has been spilled on whether the compensation of executives is appropriate, fair, or even in proportion to their absolute or relative contributions to the enterprises they head. But, on the more basic question of whether it is appropriate to pay individuals differently based on their level of productivity, the world has spoken and the answer is clearly “yes”.

Consider this question which was part of the World Values Survey 2005.

"Imagine two secretaries, of the same age, doing practically the same job. One finds out that the other earns considerably more than she does. The better paid secretary, however, is quicker, more efficient and more reliable at her job. In your opinion, is it fair or not fair that one secretary is paid more than the other?"

In only one out of 47 countries did a majority of respondents indicate this was “not fair”.

In more than half* of all countries polled, at least 80% of respondents considered this “fair”.

*Includes US, Germany, Japan, Australia and China. Canada, France & UK not polled on this question.

Source: World Values Survey Association
(iv) Reilly and Brown comment that the relationship between employee engagement and reward is tricky and often misunderstood. They cite evidence that it is more than just ‘fair play’: connecting pay to performance can have a great effect on discretionary effort; performance related pay has a particularly strong impact on the engagement of top performers. They conclude that appropriate reward practices do help improve employee engagement, especially when they are part of a ‘bundle’ of HR practices associated with high organizational performance. However the influence of reward varies by the type of employee and organizational setting; financial incentives are more likely to motivate traders than research scientists. Certain types of reward are more likely to be consistent with certain types of business strategies.

“Rather than following sectoral convoys, organizations should be experimenting to identify what drives employee engagement in their organization (and this may vary by employee group), and what part reward plays in driving engagement (again, potentially varying by employee group) and how this links to their existing business strategy.” – Reilly and Brown.

(v) If engagement has a range of drivers, what has been happening to engagement over recent years and particularly through the recession?

Based on a June 2009 survey, the McKinsey Quarterly commented that “employee motivation is sagging throughout the world – morale has fallen at almost half of all companies – at a time when businesses need to engage leaders and other employees willing to go above and beyond expectations.” They link this to less generous reward plans and go on to say that, not only had reliance on financial incentives fallen over the prior 12 months, but a number of companies had curtailed the use of non-financial incentives as well.

However other research indicates that a negative picture on engagement is not so clear cut.
A more recent Towers Watson ‘Workforce Study’\(^\text{16}\) found that engagement has been sustained in high performing organizations. However they also found a growing desire for security and stability and that willingness to move job was at a decade-long low point. There were also variations in attitudes and expectations across the workforce dependent upon organizational level, potential and also geographical location. A separate and slightly later Towers Watson study\(^\text{17}\) observed that “the recession's impact on employee engagement has been mixed, with almost a third of the companies reporting higher levels of engagement than before the crisis and a quarter reflecting lower engagement today.”

Sirota has found engagement to be reasonably stable\(^\text{18}\). However behind this there is an interesting pattern of, on the one hand, more positive attitudes towards their company’s decision-making, teamwork and planning and, on the other hand, less positive attitudes towards their company’s customer focus, keeping people informed and coaching and learning. Satisfaction with pay is relatively stable.

“Looking specifically at pay, scores on perceptions of fairness, pay competitiveness and pay for performance didn’t tank during the recession in the way that scores on job security did.” – Sirota Consulting.

Based on the above, it seems that engagement does not automatically fall in a recession.

Our own conversations with the companies in our survey support these findings. One respondent commented that, despite major declines in business orders, lower incentive plan payouts and the freezing of pay, morale had been maintained through visible leadership and ownership of reward and other communications by the CEO. Another company commented that engagement had held up and improved in some areas, possibly helped by the favourable comparison between its own stable situation and those of some of its competitors. In another organization, as reward budgets had declined, so the

### Consistency of responses to pay questions (% favourable): 2006-2009

<table>
<thead>
<tr>
<th>Question</th>
<th>2006</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
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<tbody>
<tr>
<td>How would you rate the amount of pay you get on your job?</td>
<td>44%</td>
<td>47%</td>
<td>49%</td>
<td>51%</td>
</tr>
<tr>
<td>How would you rate your earnings considering what you could get for similar work in other organizations you know?</td>
<td>43%</td>
<td>46%</td>
<td>46%</td>
<td>46%</td>
</tr>
<tr>
<td>I believe that I am compensated fairly for what I do</td>
<td>59%</td>
<td>59%</td>
<td>61%</td>
<td>58%</td>
</tr>
</tbody>
</table>

Source: Sirota Consulting
focus on talent management and employee development had increased to ensure the integrity of the employee offer.

However, longer term, companies should not be complacent. The Towers Watson study\(^\text{16}\) cites continuing evidence that the traditional employment deal (‘perform well, stay with us, and we will reward you fairly and help you grow’) is evolving into “something far more flexible and conditional, dependent not only on strategic needs and employees’ contributions and performance, but also on the demands of an ever changing business environment.” How organizations define the new deal, and how employees respond, remains to be seen. For example, if certain softer non-pay drivers are less prominent, will the financials become more important in some firms?

(vi) So what can be said about motivation and engagement and senior executives? There are of course many drivers of motivation other than money. Interviewed in 2009 as he was about to step down from his role, the CEO of Royal Dutch Shell commented:

“You have to realise: if I had been paid 50% more, I would not have done it better. If I had been paid 50% less, then I would not have done it worse.” – Jeroen van der Veer, CEO Royal Dutch Shell.

Harvard Professors Lorsch and Khurana\(^\text{19}\) commented recently that an “unexamined assumption was that executives worked primarily for money. Such rewards as future promotions, the intrinsic satisfaction of achieving results, and the pride taken in belonging to successful company were overlooked and sometimes denigrated ...”

However, the measures chosen by the remuneration/compensation committee for senior incentives will reinforce what is important from a shareholder perspective. A low or no payout will reinforce where performance has been deficient. In fact Lorsch and Khurana go on to recognize the power of executive compensation systems as shown below.

“Compensation systems always become in part ends, not simply means. By emphasising particular ends, reward systems condition the behaviour and thinking of those people who participate in them or feel their effects. Over time, they shape the business paradigm ...”

– Lorsch and Khurana.

Within this context, executive pay can certainly be a dissatisfier. One UK based practitioner commented to us:

“Executives want to get to the top of the tree and then start building wealth, especially now their pensions are being taken away. The absence of wealth generating capability seriously demotivates them. What happens when reasonable optimism about a payout has died?” – UK Practitioner.
In these circumstances, especially when strong underlying business performance or improvement is not showing through in LTI outcomes, there can be considerable tension between expectations, arguments about market pay and retention, and the principle of paying for performance.

**c) Conclusions about incentives and motivation and engagement**

(i) So what conclusions can we draw from the various theories and research findings arrayed above?

The first is that, in many, perhaps most, circumstances, **monetary rewards are not the prime motivator of engagement or top performance.** A whole range of non-financial and intrinsic rewards come into play in different ways, for different people, at different times.

The second is that **incentives are not just about monetary reward.** There is more to them than this. For example:

- Clarity and communication of key targets and priorities
- Reinforcement of critical practices shaping how results are achieved
- Feedback on performance, emphasising what is going well and where to raise the game
- Recognition of a job well done. A good incentive outcome provides more than cash.

And these are in addition to the basics of providing a vehicle for the delivery of competitive pay with a variable cost.

(ii) In fact, in that incentive plans provide a platform for promoting and reinforcing key business goals, they have become a **supporting element of the performance management system** of many organizations.

However, for this to be successful, certain conditions need to be in place, including:

- line of sight and ideally ‘line of influence’ from the employee to the targets
- targets that are felt to be realistic and potentially achievable
- effective plan communications, with visible ownership by line management.

As incentives move lower down through the organization, targets and measures may need to become increasingly localised and operationally focused. Although these are usually more distant from the ‘macro’ measures favoured by shareholders, they are likely to be more effective as engagers.
E. The survey results: what’s been happening to incentives?

(i) The aim of the survey was to obtain insight into whether and how organizations have made significant changes to their incentive plans over the last two to three years of financial crisis and recession. The focus was on both executives and other employees and on both short-term and long-term incentives. The survey was not intended to be fully representative of all sectors, or to produce definitive statistics about the incidence of certain practices – other surveys already do this. However, insight has been obtained through quality dialogue with a small number of selected organizations.

(ii) The survey was conducted via interview with over 20 organizations associated with PARC or WorldatWork. The PARC and WorldatWork researchers had extensive experience in compensation and the company representatives were most frequently the global head of reward or his or her deputy. The interviews took place between May and July 2010.

The organizations surveyed are all commercially focused and most are publicly quoted; two are owned by private equity, two are held privately and one is a profit-making public service owned by a government. During the recent crisis two companies changed owners and one became majority owned by the UK Government. Sixteen are or were headquartered in the UK, five in the US and two in Germany.

Statistics about the number of employees and revenues are shown below. Most had multinational or global operations. As can be seen, many of the companies are of considerable scale.

<table>
<thead>
<tr>
<th>Statistic</th>
<th>Employees</th>
<th>Revenues $ million</th>
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<tbody>
<tr>
<td>Highest</td>
<td>430,000</td>
<td>240,000</td>
</tr>
<tr>
<td>Mean</td>
<td>80,000</td>
<td>38,700</td>
</tr>
<tr>
<td>Median</td>
<td>37,500</td>
<td>10,500</td>
</tr>
<tr>
<td>Lowest</td>
<td>950</td>
<td>550</td>
</tr>
</tbody>
</table>

The companies come from a wide range of commercial sectors as follows:

<table>
<thead>
<tr>
<th>Sector</th>
<th>Count</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial services</td>
<td>5</td>
</tr>
<tr>
<td>Retail and leisure</td>
<td>3</td>
</tr>
<tr>
<td>Telecoms and hi-tech products</td>
<td>4</td>
</tr>
<tr>
<td>Manufactured goods including food</td>
<td>3</td>
</tr>
<tr>
<td>Health care and health products</td>
<td>2</td>
</tr>
<tr>
<td>Business information and publishing</td>
<td>2</td>
</tr>
<tr>
<td>Oil/energy</td>
<td>2</td>
</tr>
<tr>
<td>Outsourced services and distribution</td>
<td>2</td>
</tr>
<tr>
<td>Total</td>
<td>23</td>
</tr>
</tbody>
</table>
(iii) The high level finding of the survey is that, partly because of the recession and partly despite the recession, there has been considerable change to incentives over the last two to three years. Nearly one third of the companies we spoke to had made changes driven by the recession. Half had made changes for other reasons. Together, over three quarters of companies had made significant alterations to their plans.

As the pie chart below shows, seven companies made changes due to the recession, ten for other reasons and five made no significant change.

**Survey: changes to incentives 2008-2010**

<table>
<thead>
<tr>
<th>Change for other reasons</th>
<th>Change due to recession</th>
<th>No significant change</th>
</tr>
</thead>
<tbody>
<tr>
<td>11</td>
<td>7</td>
<td>5</td>
</tr>
</tbody>
</table>

Around two-thirds of companies changed their STIs and around one-third changed their LTIs (with most of these changing both STIs and LTIs).

The rest of this section will describe the actions taken by our survey companies and consider whether any particular trends are emerging from this. The subsequent section will interpret the findings in the context of our discussion on motivation and engagement. A summary of each company’s survey response is shown in Appendix.

(iv) Seven companies said that the recession led to significant change to incentives (Companies A-G).

In most cases these changes followed major declines in markets with severe impact on profitability; as a result prior incentive structures or measures were no longer considered appropriate for the new and volatile circumstances. Some of the actions involved discretionary ‘workarounds’ to produce an incentive outcome that took better account of the context and circumstances of the performance, e.g. Companies A, B and C. Others involved changes to measures or additions to measures going forward so that the plan (usually the short term incentive) continued to be relevant and challenging but fair, e.g. Companies D, E and F. In the other case, Company G, the financial crisis led to a thorough restructuring of incentives and, particularly, governance processes.

To some extent it is surprising that more organizations did not need to adjust their incentives because of the volatility. However we found that a significant proportion of our survey companies continued to increase profits over the period. In some cases this may be because their markets did not suffer over the period; in others it may be due to the company actions to protect or increase
We also observed that certain existing practices strengthened a plan’s ability to cope with the volatility that was experienced. These features provided flexibility through:

- Application of informed judgement to the determination of the performance outcome versus target by considering both actual results and results adjusted for major changes outside the unit’s control, e.g. Company K
- A high level of discretion in shaping incentive funding and outcomes via a pool and a non-formulaic distribution system, see Company I.

Aside from impacting incentive outcomes directly, the need to manage costs (and optics) during a recession may mean that improvements to incentive plans, e.g. extension of the plan to additional staff or a more generous level of target bonus, can no longer be implemented and must be deferred. This was the case for two of our survey companies.

(v) Eleven companies made changes to their incentives for reasons not primarily caused by the recession (Companies H-R).

These changes include:

- **Improving risk management** of reward in financial services companies, e.g. Companies H, I, and J. Only one company outside financial services mentioned conducting a risk audit on its compensation systems. The recent Hay incentive survey on incentives similarly found only a small proportion of UK companies citing risk as a driver of change in their variable pay programs.

“We remain concerned that many companies have yet to come to terms with the level of risk that they carry in a variable pay program – financial, operational and reputational risk – and have simply put the question aside.” – Hay Group.

(vi) Five companies said they had made no change or only minor tweaking (Companies S-W).

Certain of these companies had made significant change just prior to the recession, e.g. one company had implemented a new variable pay plan simplifying and standardising practice across the globe; another had extended its annual variable pay plan further down the organization. Others found that the
recession confirmed that their existing model seemed to be working well and that change was unnecessary.

As explained above, we also found that certain incentive plan practices provided a flexibility that enabled their plans to accommodate the volatility.

(vii) Design trends:

We had thought that we might see a major increase in the use of ‘discretion’ – which we have defined as ‘the use of informed judgement in after-the- event assessment’. A small number of companies did see an increased role for discretion where, for example, informed judgement was felt to lead to more balanced outcomes for business performance, more effective allocation of LTI grants or simply being a necessary ingredient of assessing individual performance. However, most companies reported no change in the use of discretion, including those for whom it is a significant feature already, e.g. banks.

We asked some of our survey companies where they felt their short-term plans would sit on a continuum between ‘pre-performance incentives’ and ‘post performance rewards’. Most felt that their arrangements were closer to the ‘incentive’ end of the continuum. This is consistent with the point above. Interestingly however, because of their use of discretion, certain of the banks felt their bonuses were closer to ‘post performance rewards’. This difference with other sectors may reflect the profit-sharing nature of bonuses in investment banking – and perhaps also the importance of competitive pay in an employment market not exemplified by strong organizational loyalty.

Other factors may also come into play. Certain respondents commented that some geographic cultures seem more comfortable with the use of judgement than others which prefer a more formulaic approach. There may also be an issue of trust here. Organizations which have a high level of trust in their management may feel more comfortable with judgement, especially where there is a track record to take that into account.

Although, because of volatility, one organization moved to a relative measure for its LTIs and another introduced relative performance as one of the lenses informing the outcome of its medium-term bonus, we found no major trend towards stronger use of relative performance.

The most noticeable trend, exhibited in over a third of our respondents, was towards an increased number of measures. Although the stated reason is based on the appropriateness of the new measures, a higher number of measures reduces potential volatility in the overall outcome. An increased range of measures seems consistent with the trends identified by UK consultancies.
However the trend to a higher number of measures may lead to greater complexity which can reduce understanding and therefore effectiveness. At least five organizations mentioned that they had either completed a standardisation/simplification process or were feeling an increasing need to consider one. So the trade-off between comprehensiveness/reduced volatility and increased complexity may become a potential problem that needs addressing at some stage.

(viii) An interesting point of context for these recent changes is that, for at least one year, a majority of our respondents had frozen the base salaries of their executives and awarded relatively constrained increases for other staff. In these circumstances, the short term incentive was the major ‘movable part’ and so getting it right may have been considered even more important than at other, more normal, times.

(ix) In terms of variable pay outcomes for 2009, although some were clearly below target, a majority of the respondents who were asked about this reported that their STI payouts were at or above target. This positive outcome reflected various factors for different companies. These included consistent strong performance, significantly improved performance versus the prior year, and adoption of targets for 2009 that took the poor business context into account. Survey data from UK consultancies supports the finding that payouts for 2009 were generally higher than those for 2008.
F: Interpreting the results: what do we make of this?

(i) The effective design of incentives tries to combine and reconcile various factors, such as ‘alignment to business strategy’, ‘good governance’, ‘market competitiveness’, ‘cost/affordability’, ‘pay for performance’ and the ‘motivation/engagement’ of the participants. Our study of changes during the recession found organizations adjusting their incentives primarily for reasons of ‘alignment to business strategy’, ‘good governance’ and ‘motivation/engagement’.

(ii) Interestingly, our feeling is that some practitioners are reticent to use ‘engagement/motivation’ as an explicit reason for making changes – it can sound ‘soft’ or potentially weakening the principle of pay for performance. However making appropriate changes to support engagement is actually well grounded in the research: although non-financial factors may do more to engage and motivate, poorly designed reward plans can be dysfunctional. Given the place that short term incentives increasingly have in supporting and reinforcing organizational performance management, this is not desirable.

So, where companies took action to change their plans because of the recession, they may have been addressing engagement by avoiding disengagement/demotivation. Plans which fail to recognize high performance in some areas of the organization, targets which are viewed as unachievable, or measures which have little line of sight, do not enable an incentive plan to provide focus and reinforcement of what is important in the current year. Nor do they support trust in management. Sceptics might counter that changing the measures is simply a continuation of the trend of regularly adjusting performance measures when they do not payout as expected. However priorities do change and keeping incentives relevant makes practical business sense.

(iii) Although operating several measures may generate additional complexity, the balanced score card (which allows for a focused selection of higher-level financials, operational targets and critical factors such as safety, customer satisfaction etc.) may provide a better platform for engaging staff. The recent Hay report comments as follows:

“A narrow focus on financial return has the potential to skew behaviour towards ‘revenue/sales/cost savings by whatever means necessary’. It also tends to disengage the majority of employees who are motivated by more than financial success and who want to be part of an enterprise or goal that they can believe in.” – Hay Group.

(iv) Given the nature of our survey, so far in this report we have tended to assume that volatility equates to the financial crisis and the recession. However in relation to incentive plans, volatility or ‘turbulence’ may also be a result of natural events (e.g. severe
disruption of the local market; commodity shortage causing price spike; volcanic ash disrupting flights) or corporate calamity (e.g. a major safety, quality, environmental lapse or fraudulent event that severely damages the company’s financial position and reputation). Each of these situations may require the application of careful judgement in how to handle incentives.

Where the event originated outside the company, there is the question of whether to mitigate the effects of the event or to let the results stand.

Where the event originated inside the company, there may be the issue of how to handle the STI of those employees within the originating business, i.e. how to reflect what has happened appropriately, for example with no payout, and how to look forward to support the necessary efforts to rebuild and recover, for example with a new plan that captures these imperatives. In considering incentive outcomes across the wider organization, and assuming that affordability allows, it may be helpful to consider different categories of employee and so distinguish between those running the corporation, those in the chain of command to the originating unit, those in the division containing the originating unit, those in the originating unit itself and then other employees who are more distant from the centre of the event.

With these types of volatile events, most LTIs will probably look after themselves if they have performance measures. Also many employees will feel the negative impact of the depressed share price through their own shareholdings. These equity effects are probably appropriate given the experience of the wider shareholders.

(v) So, to reiterate what we have learnt:

- Financial incentives are not the prime motivator but they do provide a consistent framework that supports and reinforces the performance management of the organization
- They shouldn’t be static: there is a continuing need to make adjustments to incentives from time to time, particularly to align with the business strategy, operational imperatives and occasionally for reasons of good governance
- In volatile environments – such as we have seen over the past two years – companies may need to make swift changes to their incentives or apply informed judgement to ensure that the plans continue to be perceived as relevant, fair and achievable. If organizations do not do this, the plans may become ineffective or dysfunctional
- Whatever the circumstances, changing incentives requires a careful balancing of the competing design factors.

As one seasoned reward practitioner commented to us:

“Reward may not ‘motivate’ performance but it can ‘drive’ performance. You reinforce what you want to do by putting the reward plan behind it. However new things can become a given after a couple of years and you need to move on. Incentive plans are a great opportunity to communicate what you want to achieve, providing they are fit for purpose in doing that. Sadly, not all of them are.” – UK Practitioner.
a) The justification for incentive payments

(i) In the end, the justification for incentive payments has to be financial. These payments have to generate a return greater than their cost. In a commercial enterprise, there can be no other rationale. The financial performance of the company has to be greater as a consequence of making such payments.

(ii) The linkage need not be instantaneous, i.e. employees can be rewarded for achievements that are expected ultimately to result in enhanced financial performance but that do not necessarily do so in the period under assessment. This may include non-financial aspects such as safety performance or customer service, or it may include business developments that are not yet being fructified, such as start-up or strategic initiatives. It can also embrace the making of incentive payments to maintain engagement and motivation when financial circumstances are adverse – e.g. recession or company incident – in the belief that this will ultimately result in better performance when the financial environment becomes more benign.

It is management's role to identify which actions and behaviours will lead to improved financial performance, and to inculcate these as necessary within their organization. It is also their role to determine how much effectively to pay 'in advance' – whether in reward of non-financial or development achievements, or to sustain engagement in difficult times. Management therefore must be judged on their ability to make these assessments as viewed through the lens of performance of the company over time – hence the importance of longer-term reward for senior executives.

(iii) It can also be relevant even for senior executives to have incentives based on non-financial measures to keep them focused on the underlying drivers of performance. This should help ensure internal alignment and engagement, as well as the need to care for external reputation via relationships with potential customers, partners, and those awarding licences to operate. However, the emphasis needs to be on delivered results over time. Shareholders are tolerant of non-financial measures because they appreciate how damage to reputation can erode a company's value, but their priority is rightly aimed on whether the management team, through their decisions and actions, delivers acceptable performance which translates to share price and dividend growth.

b) The design of incentives

(i) It is important that employees have clear objectives which are relevant to their
personal roles. Employees also need a clear framework and set of values so that they have scope to utilise their skills and judgements within an approved context. The way employees respond to changing market and business circumstances can be a key source of competitive advantage.

Undoubtedly it makes sense for reward incentives to align with these principles and to clearly support and reinforce what employees are expected to do.

It is also imperative that the payments from such incentive programs are seen to be fair: relative to the performance contribution made in the prevailing circumstances, relative to the rewards received by colleagues, and relative to the rewards received by peers in other organizations.

(ii) In terms of performance measures, a key factor is ensuring that the nature and balance of the measures are appropriate for the organization. This means taking account of the challenges the organization faces and of the plan participants who may vary from shop floor workers to main board executive directors.

The range of potential measures is wide: from operational ‘inputs’ that ultimately drive profitability, through to key financial ‘outputs’ such as profit itself, as well as investor focused measures such as relative total shareholder return (TSR) or shareholder added value. Measures can be positioned at different organizational levels: from the individual to the plant or store; to the district or country or region; to the division or function – up to the total corporation. Targets appropriate for the front line (for example, short-term and more local operational and ‘input’ focused measures) may be different from those which are appropriate at the top (corporate, more ‘output’ or investor focused measures, often geared to the longer term).

(iii) In addition to the above issues, there are other dilemmas or dimensions inherent in incentive design and operation. For example:

- Using multiple measures vs keeping it simple
- Keeping it current vs keeping it constant
- Following market practice vs customising to strategy.

Management needs to judge how best to reconcile these dilemmas, and to test the balance frequently.

Our study has made us conscious of two other dimensions that may be useful to consider when reviewing incentive structures:

- ‘Incentives vs ‘rewards’
- ‘Pay for performance’ vs ‘perceived fairness’.

(iv) ‘Incentives’ vs ‘rewards’: in this dimension, ‘incentives’ represent the traditional approach stemming from the belief that setting performance targets and paying for achievement of them creates an incentive to perform and provides clear
alignment with business priorities. Mantras such as ‘you get what you pay for’ or ‘what gets measured and rewarded gets done’ often accompany this approach. ‘Incentives’ represent an ‘if then’ conditionality and approach to variable pay, as coined by Daniel Pink.

This is the predominant approach. It provides considerable flexibility. It can also provide clear alignment with the business targets. And because such arrangements can be, and often are, adjusted/amended each year to take account of changing business requirements, they can be seen to be progressive. The practice is, however, largely formulaic and does not provide much scope to respond to change within a performance period. Verification processes are required to ‘keep score’ – though only a light governance process is required as few decisions need to be made because of the formulaic nature of the programs. It may not, however, adequately encourage discretionary effort – employees may become conditioned to aim solely for the specified targets, and not necessarily strive to go any further. They may seek to ‘game’ the system by withholding value creating inputs until the next measurement period if the target has already been reached.

The alternative ‘rewards’ approach communicates business objectives and targets but the pay equation is only determined once performance outcomes are known. In this process, there is a retrospective assessment using full information on what has been achieved and the circumstances in which it was delivered. The idea is that a fairer assessment of appropriate levels of reward payments may be made based on a fuller understanding of the risks and difficulty entailed. This method provides encouragement for employees to go beyond stated business targets. These types of incentive are closer to the ‘now that’ rewards favoured by Pink.

As mentioned, most of our survey companies said their reward plans were closer to the ‘incentive’ end of the spectrum. The exceptions were certain of the banks, where some of their plans felt closer to the ‘reward’ approach – especially with their bonus pool arrangements. The difference may in part stem from the profit sharing nature of many investment bankers’ bonuses as distinct from the multiple-target type of incentives that apply in many other businesses.

And as we found from our survey, the ability to exercise a measure of informed judgement in assessing performance outcomes provides a degree of flexibility and resilience that enabled some plans to weather the volatility of the recession.

The actual mix of measures and positioning on the relevant dimension will depend on various factors including the lenses shown overleaf. Each factor merits consideration and can together act as a guide for where to position variable remuneration.
Factors to consider when designing the incentive mix

Type of company
What is the business strategy and organizational model? A company working in teams to deliver collective
goals will likely see a different approach from one consisting of a series of largely separate business units.
What is the business sector? Awareness of competitor practices is important potentially to identify
successful approaches used elsewhere but also to understand what may be benchmarks used by
employees.

Types of roles
Roles with relatively simple objectives (such as sell or make more or use less) may be suited to rewards
directly related to those objectives alone. Where objectives begin to interact (e.g. sell more but with a
specified level of customer service, or make more with specified quality levels), setting incentive
performance targets in advance takes on an additional level of complexity with targets potentially conflicting
and judgements required to be made. Clearly where multiple objectives are involved, say at management
levels, it becomes increasingly difficult to capture all of them in a methodical incentive plan.

Relationship between operating margin and employment costs
What is the total fixed reward cost, and what is the variable reward cost? How do these compare to the
operating margin? How much control over the variable reward cost is required? High margin operations can
‘afford’ to operate a buffer incentive approach though this will be tougher for low margin businesses.

External/social standing
Public, as well as stakeholder, sentiment can be influential. It can be necessary to include certain factors in
performance targets to show such stakeholders that they are being seriously addressed. Examples would
include the recent experience with banks needing to show their commitment to factoring risk into their
executive reward models, and companies involved with major incident would need to show that they are
recognising the importance of solving the cause of the incident with reinforcement through incentive targets.

Governance structure
An incentive plan which is more judgementally based will require much stronger and better established
governance processes than one which is largely driven by formulae. This applies to governance within the
compny as well as externally with shareholders.

Levels of trust
A formulaic target based approach is less dependent on levels of trust as the mechanical calculation does
the job. Anything more judgement based needs high levels of trust that determinations are fairly made and
not just always positively (shareholder suspicion) or negatively (employee suspicion).

Cultural situation
Different cultures/nationalities can be better suited to different forms of incentive approach. Some are more
comfortable with specific targets and payment outcomes set in advance whilst others might favour a more
retrospective appraisal that allows for the full range of their input to be taken into account.

Communication processes
Communication of reward plans is a good way of simultaneously communicating business priorities.
However, even if incentive plans do not use business targets as specific performance measures they would
still need to be communicated as the business framework within which performance will be assessed.

Barriers/drivers to change
The timing of any change in incentive approach can be critical. How much else is changing? Is reward a
sufficiently high priority, or are there other more pressing engagement factors to be solved? Are there
concerns about moving away from competitor or market practice and does the company have sufficient
credibility (with employees and with shareholders) to drive through the change.
‘Pay for performance’ vs ‘perceived fairness’:
this dimension concerns the balance
between the appropriate level of incentive
pay ‘earned’ for a given level of company
financial performance versus the
appropriate level of performance pay to
remain market competitive and/or sustain
motivation and engagement by being seen
to be rewarding equitably.

- The former relates strongly to the delivery
  of financial results, together with the cost
  and affordability of the performance
  payments against the amount of value
  added
- The latter is more founded on the desire to
  ensure that employees are clearly
  rewarded for their overall contribution –
  which may not be directly related or
  connected to a company’s financial
  results, or indeed to the value they have
  added. However, as noted earlier, all
  incentive payments must ultimately be
  justified by the amount of value added. In
  some respects, therefore, payments of this
  nature can be regarded as a form of
  payment ‘in advance’, or indeed as a form
  of ‘buffer’, i.e. that when profits are
  adversely affected by external
  circumstances not all is taken away,
  though when profits are benefitted by a
  favourable economic environment not all
  upside is rewarded
- Positioning on this dimension may reflect
  the perceived nature of the incentive within
  the organization. If, in essence, it is a profit
  share then financial performance will be
  prime. However, if the essence of the plan
  is the reinforcement of a range of
  challenging annual targets across the
  organization, then the financial outcome
  will be as important as its weighting in the
  plan, assuming ability to pay. These
  considerations may also be helpful when
  making judgements around the intended
  reward for say ‘strong performance in a
  bad year’ versus ‘average performance in
  a good year’.

Variations in practice across the above
dimensions occur within both listed
companies and private enterprises.
Sometimes there may be a combination of
approaches, perhaps with different
emphases at different employee levels or
in different parts of the business.

In times of heightened awareness and
sensitivity, communicating the basis for
incentives is even more important. Now more
than ever, external observers need to
understand incentive arrangements and
employees need to feel that these
arrangements are challenging but
attainable.

c) Can short-term incentives
support both performance
and engagement?

We suggest that, subject to affordability
and resources, there are few
insurmountable barriers to creating STIs
that can support and reinforce both
performance and engagement. The
moves towards use of a wider range of
measures probably strengthens the
ability of incentives to reinforce a range
of business goals – provided that plans
do not become too complicated or
unwieldy that they cannot capture
employee understanding or interest.
Importantly, shareholder organizations appear broadly comfortable with a mix of financial and non-financial targets in short term incentives providing they are relevant and their operation is transparent.

Annual bonuses should be clearly linked to business targets, ideally through the KPIs reported in the Enhanced Business Review*. Where other measures are chosen these should be explained and justified. The KPIs can be both financial and non-financial. The measurements chosen should be quantifiable and the targets chosen should be set at the start of the year. The performance measures and targets should be publicly disclosed. If the targets are considered to be commercially sensitive they should be disclosed post hoc.

* A section of the Annual Report

Association of British Insurers

(ii) Our comments above have focused on design. However, effective incentives are just as dependent on implementation and operation. Good communication of incentives and progress made requires resources, particularly line manager time. If the incentive plan excites the line manager, he/she is much more likely to make it part of team communication and business management. And it is then more likely to engage the team.

d) Can long-term incentives play a similar role in engagement?

(i) Most of our survey and most of our discussion has focussed on annual incentives. As discussed earlier, for the executive population in particular, there is also a strong requirement for alignment with longer term performance as this assesses the success of the strategies and actions taken.

The most powerful aspect of short-term incentives is their immediacy. They tend to get assessed and paid shortly after the end of the performance period that they relate to and they can be quickly amended for the next financial year. They have relevance and timeliness. Spot bonus recognition awards are even more closely linked. This is not the case of course with long-term incentives – they tend to cover at least three years and often have overlapping performance periods.

Long term incentives represent both a significant cost to companies and a primary source of wealth creation for executives. If the purpose of most short-term incentives is to reward and recognize achievement of challenging annual targets or to provide a share of annual profits, the purpose of LTIs has traditionally been about alignment with shareholders and sharing in their long-term financial success.

(ii) Compared with annual incentives, it is less clear to us that long-term incentives are as effective at supporting and reinforcing engagement.
“If asked, most executives would say they are not engaged by their long-term incentives.”
– UK based practitioner.

“No-one understands...[LTIs]...neither the shareholder, nor the supposedly incentivised executive, nor even the remuneration committee which acts as referee” – Anthony Hilton, Financial Editor, Evening Standard.

This may be down to the nature (or absence of) the measures used or, perhaps, the complexity of multiple plans across multiple time periods and/or, for some recipients, the extended line of sight. There are also related concerns about whether the current LTI structures actually generate a good correlation between the value added to shareholders and the reward received by the participants. Some commentators cite the powerful alignment-generating qualities of executives holding significant levels of company stock for long periods. Others are less persuaded. Indeed LTI practices vary across countries and organizations suggesting little consensus on how best to use them. There are varying trends. For example, some organizations have increased use of restricted stock without performance conditions. Others support the introduction of a wider range of performance measures for LTIs. Plus, recent proposals have been made for very gradual unwinding of executive stock holdings. This is one area where additional work could be usefully applied so that greater clarity can emerge. Our current research did not aim to debate this conundrum.

However, we believe it is appropriate to pose three questions:

- Do the current forms of LTIs represent a missed opportunity to engage and motivate the executives and senior professionals who receive them?
- Do LTIs actually change behaviour – or are they mainly a mechanism to provide appropriate transfer of wealth from the company to its executive agents?
- Do current LTIs provide payouts that represent a satisfactory reflection of the value added for shareholders and an acceptable level of wealth creation for the participants?
Our overall findings

- Financial incentives are not the prime motivator for most individuals but they can support and reinforce the management of performance across the organization.

- Incentives need to be dynamic with a continuing need to make adjustments to align with the business strategy, operational imperatives and for reasons of good governance.

- In volatile environments companies may need to make swift changes to their incentives or apply informed judgement to ensure that the plans continue to be perceived as relevant, fair and potentially achievable. If organizations do not do this, the plans may become ineffective or dysfunctional.

- Whatever the circumstances, changing incentives requires careful balancing of the competing design factors. These may usefully include understanding whether incentive programmes are to be forward-looking ‘incentives’ or retrospective ‘reward’ mechanisms and also consideration of the right balance between financial performance and perceived fairness. The answers may vary for different levels within an organisation.

- Incentives must generate a return in excess of their cost. While there can be reasons to reward performance that doesn’t generate an immediate return, it is clear that value has to be ultimately generated and measured in some logical manner and this is the role of the long-term incentive.

- How well LTIs currently do this, whether they truly engage their participants, and whether they appropriately reflect the longer term value added are important questions.

- In times of heightened awareness and sensitivity, communicating the basis for incentives is critical. Now more than ever, external observers need to understand incentive arrangements and employees need to feel that these arrangements are challenging but potentially attainable.
H. References:


34 Developing Performance Incentives and Sustaining Engagement in a Volatile Environment.
## Appendix: Summaries of survey company actions

<table>
<thead>
<tr>
<th>Company</th>
<th>Description</th>
<th>Profit change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Company A</td>
<td>Although most divisions performed strongly and were profitable, severe difficulties in one major division resulted in a major downturn for the group in 2008. The short term incentive plans had a group profitability gate and, as a result, no payout was due in the profitable divisions. The company decided to make discretionary payouts in the profitable divisions so that there was some (albeit low level) recognition of their performance. The process of exercising informed judgement rather than a mechanistic formula has been retained. An additional measure of free cash flow was added to the long term incentive which was previously based on relative TSR. Free cash flow is felt to provide a closer line of sight and reinforces efforts to raise profitability. Implementation of enhancements to board member reward was deferred.</td>
<td>Profit increased in 2009</td>
</tr>
<tr>
<td>Company B</td>
<td>Sales and operating profit fell significantly in the latter half of 2008. The company felt that the existing STI framework needed a temporary workaround for 2009. Financial targets were softened but these had to be fully met for there to be any pay out, in other words there was no threshold. The personal performance element was reduced. Thresholds were reinstated for 2010 but the personal element was removed altogether.</td>
<td>Profit reduced in 2009</td>
</tr>
<tr>
<td>Company C</td>
<td>Demand for its product crashed in 2008 and losses were incurred. The STI ceased to be realistic. It was replaced with a new plan with reduced financial targets and with bonus opportunities cut by 50%. For 2009, the personal element of the plan was eliminated enabling a stronger focus on financial and operational performance. The business was taken over during 2009.</td>
<td>Profit reduced in 2009</td>
</tr>
<tr>
<td>Company D</td>
<td>The company made a loss in 2008. It wished to raise the focus on sustainability and reduce the emphasis in its package on short term performance (cash bonus) and the share price in its LTI (primarily options). It therefore introduced a ‘mid-term’ three-year plan focusing on the underlying book value of the company.</td>
<td>Profit increased in 2009</td>
</tr>
<tr>
<td>Company E</td>
<td>Net income fell severely in 2008. Up to 2008, the STI business measures utilised one measure: EPS. There were no or low payouts in 2008. Following reconfiguration, the plans now have two operationally focused financial measures (revenue and net operating income). These are felt to provide stronger line of sight to participants.</td>
<td>Profit reduced in 2009</td>
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<td>Company</td>
<td>Description</td>
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<td>Company F</td>
<td>The operation of the company’s variable pay plans was somewhat opaque and was felt to need optimising. Earnings suffered a major collapse in 2009 with resulting low awards. The volatility meant that senior management considered that targets for the full year would be wrong one way or another. For 2010 targets were set for the first half of the year; those for the second half of the year were set at mid-year. Some non-financial milestones were introduced. The intention of extending the plans lower down in the organization was shelved.</td>
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<td>Profit reduced in 2009</td>
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<td>Company G</td>
<td>Severely impacted by the financial crisis. There was no payout for incentive plans relating to 2008. There is a five year recovery plan. For 2009 onwards, bonus targets relate to the strategic plan designed to return the group and its divisions to stand alone strength. Incentive plans and governance processes have been restructured to take greater account of and adjustment for risk, to provide for deferral and for clawback. Divisional performance and the relationship between divisional assessments and the performance of the group as a whole are taken into account in assessing the size of bonus pools. Bonus pools are then allocated out taking account of individual performance and market pay levels. A new LTI has been introduced with vesting based on five key metrics form the strategic plan.</td>
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<td>Losses reduced in 2009</td>
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<td>Company H</td>
<td>Regulatory changes were felt to require a more consistent executive compensation structured globally as well as simpler and more transparent incentives with enhanced focus on sustained performance. The plans applying to the executive cadre were simplified with a reduction from four to three principal elements (share options were discontinued). The elements were combined within one overarching plan emphasising sustainability. The mid-term plan has a stronger focus on the competitive/relative and sustainable development of the relevant business portfolio over a three year period. Outcomes will be determined using informed judgement at the end of the three-year period. Various changes have been introduced to manage and mitigate risk.</td>
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<td>Profit increased in 2009</td>
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<td>Company I</td>
<td>Profits collapsed in the latter half of 2008. The new environment was taken into account in setting business targets for 2009. This and the discretionary nature of the STI enabled the existing structure to continue to operate and reflect the changed circumstances. The principal changes were driven by regulation: stronger adjusting of outcomes for risk; and the deferral into equity of a higher proportion of bonus awards.</td>
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<td>Profit reduced in 2009</td>
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<td>Company</td>
<td>Changes/Incentives</td>
<td>Profit in 2009</td>
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<tr>
<td>Company J</td>
<td>The changes were driven by regulation and included a strengthened process of adjusting of outcomes for risk and the deferral into equity of a higher proportion of bonus awards.</td>
<td>Profit increased in 2009</td>
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<tr>
<td>Company K</td>
<td>The primary LTI of executives and senior managers focused on TSR. The perceived value was discounted by some participants and their line of sight to TSR was considered to be over-extended. To address this, TSR was restricted to plans applying only to the top levels of executives. Additionally, the allocation of LTI grants to executives became less formulaic (value to the company rather than simply grade). The STI for executives was aligned with the plan structure applying to all other employees to simplify plans and processes. Although there was a high level of profit volatility during 2009, short term incentives continued to function well. This was aided by an existing practice of applying informed judgement to the determination of the performance outcome versus target by considering both the actual results and results adjusted for major changes outside the unit's control.</td>
<td>Profit reduced in 2009</td>
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<tr>
<td>Company L</td>
<td>The STI was hardwired into financial measures particularly profit before tax (PBT). A cash flow measure was added to avoid an over reliance on PBT. An absolute TSR target was added to the relative TSR element of the LTI which also includes PBT.</td>
<td>Profit increased in 2009</td>
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<td>Company M</td>
<td>Executive bonuses were based on 50% financial and 50% non-financial measures. The weightings of the measures were rebalanced and corporate debt was dropped as a measure as this had ceased to be a pressing business issue.</td>
<td>Profit increased in 2009</td>
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<tr>
<td>Company N</td>
<td>Board level incentives were reviewed. The STI was realigned to more closely reflect business strategy and the financial measures underpinning this. For the LTIs, and reflecting the economic uncertainty, absolute EPS was replaced by relative EPS in one plan and by relative TSR in another. For executives, STIs focus on financials and behaviours with behaviours acting as a multiplier. The company experienced no pressing need to make significant changes to these or to the plans applying to most employees, although a case for simplification may emerge.</td>
<td>Profit increased in 2009</td>
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<td>Company</td>
<td>Description</td>
<td>Result</td>
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<td><strong>Company O</strong></td>
<td>The business had to be transformed to be able to win and retain the home market operating licence for the next 10 years. Part of this transformation was to develop a stronger performance culture and individual performance management system. To support this, a personal performance element was introduced into variable pay to supplement the existing two business measures (corporate sales and corporate profits).</td>
<td>Profit increased in 2009</td>
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<td><strong>Company P</strong></td>
<td>The company is in the middle of a multi-year turnaround and the form of the short term incentive has been shaped by this. For example the outcome of the prior year's performance becomes the threshold for the following year's bonus measure. This practice was retained through the period. However two key changes were implemented: cash was introduced as a measure (in addition to revenues and ebitda) to reinforce the priority of repaying bank covenants; a personal performance element was introduced below the board.</td>
<td>Profit increased in 2009</td>
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<tr>
<td><strong>Company Q</strong></td>
<td>The primary driver of change has been company strategy, specifically the addition of a new internet based business and a reappraisal of the drivers of the traditional retail business. To reflect a new type of employee and the recognition that in the new organization individuals could make more of a difference, a significant personal element was introduced into the short term incentive. To reflect an increased focus on the customer experience provided in the retail division, the variable pay plan for shopfloor staff moved from being district based to reflecting the performance of the individual store. The performance drivers for long-term incentives now require a focus on growth.</td>
<td>Profit reduced in 2009</td>
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<td><strong>Company R</strong></td>
<td>The primary driver has been the need to simplify after a merger in 2007. Over three years, senior reward has moved from nine different scorecards and thirty-seven measures to one new system under which a company-wide bonus pool is determined based on one scorecard comprising three measures (cashflow, margin and customer focus). The bonus pool is then allocated out to divisions and then to individuals.</td>
<td>Profit outcome for 2009 not available</td>
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<td><strong>Company S</strong></td>
<td>No change needed during the recession. However the STI was substantially revised during 2007, driven by a stronger focus on the key performance drivers of each business and a keen desire for global standardisation. A corporate financial gate/threshold was discontinued and the plan now centres on business unit and individual performance. The assessment of performance is largely formulaic rather than based on judgement.</td>
<td>Profit reduced in 2009</td>
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<td>Company</td>
<td>Description</td>
<td>Profit Outcomes</td>
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<td>Company T</td>
<td>A 'hard-nosed' focus on financial and service measures continues to work and reflects the results as they fall helping to support the growth of a more commercial culture within the organization.</td>
<td>Profit increased in 2009</td>
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<td>Company U</td>
<td>No major change although plan weightings were aligned in support of standardisation/consistency.</td>
<td>Profit increased in 2009</td>
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<tr>
<td>Company V</td>
<td>The existing STI approach that splits equally between corporate, business and individual performance proved resilient. No change was made to LTIs (options and restricted shares).</td>
<td>Profit reduced in 2009</td>
</tr>
<tr>
<td>Company W</td>
<td>The current approach proved resilient; corporate and business performance (ebitda) generates a pool; individual awards are based on judgement informed by personal performance/appraisal weighting. In 2008 the existing short term incentive was extended further down the organization.</td>
<td>Profit outcome for 2009 not available</td>
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</table>
Developing Performance Incentives
and Sustaining Engagement
in a Volatile Environment

November 2010