BOARDMEMBER.com

April 01, 2013

Getting More Mileage from Your Incentive Plan

by Bertha Masuda and Susan Schroeder

The overarching goals of executive compensation programs are to motivate executives to drive corporate performance and to retain high performers. Yet many large public companies fail to get the intended motivational and retentive value from their programs because executives don't grasp the full potential of incentive plans.

This gap between executive perception and potential rewards has grown wider as incentive plans have become increasingly complex. This complexity includes layers of annual grants that use different types of equity, such as performance-contingent and time-based equity vehicles, overlapping measurement periods, and performance targets that change over successive years. Understandably, it's difficult for executives to understand the amounts of incentive pay they might receive under various positive performance scenarios.

If executives can't see this potential, how can they be motivated to drive corporate performance as vigorously as an incentive plan is designed to encourage? And if executives' vision of potential wealth accumulation isn't as lustrous as that suggested by the plan's combined elements, how can their desire to stay with the company be as strong as the compensation committee had hoped? Ironically, companies that don't achieve intended performance goals may nonetheless suffer optical damage from plans deemed too generous by Institutional Shareholder Services.

Companies can bridge this rewards/perception gap by translating each feature of their incentive plan into numbers using a dynamic quantitative model that shows executives how much they'd receive under different scenarios. By using this kind of demonstration, companies can give executives a sense of their potential rewards, and can show them how much money they might leave on the table at any point if they leave the company.

To construct such demonstration models, companies don't need to create a new IT group or assign their HR staff to six months of training. Instead, they can simply use Microsoft Excel to create a calculator that incorporates values and vesting schedules for all pertinent plan elements. Users have the choice of inputting their own share price assumptions, and performance or other plan metrics. This dynamic model shows the impact on total compensation one, two and three or more years out.

This calculator displays rewards in color-coded bar graphs. The performance variables go in designated fields where executives can input target share prices or growth rates (e.g., a doubling of the share price). In our experience with this calculator, executives' reactions to rising compensation bar graphs can accurately be described as eye-popping. It's one thing for executives to read the package of plan documents and do some back-of-the-napkin arithmetic applying the share price to the current year's inventive formula. It's quite another for them to see the cumulative effect of rising share prices on their aggregate equity holdings.

Because executives manipulate the calculator themselves, the results seem more palpable. By literally being hands-on in the demonstration, they develop a greater sense of ownership and control of their financial destiny.

Using this calculator to demonstrate potential rewards can be highly motivational for top-five executives, but it may be even more effective—and critical—for the top 25. Unlike C-suite executives, the top 25 are less likely to have personal lawyers who keep track of every dime for their clients. Moreover, as these executives may include future candidates for top-five positions, the retentive value of assuring that they understand their potential long-term rewards dovetails with succession-planning goals.

This calculator is what's missing from the materials that companies typically present executives. By adding it, companies can introduce a dynamic quantitative dimension to demonstrate potential compensation, enhance performance motivation and foster retention.

Bertha Masuda and Susan Schroeder are partners in Vivient Consulting, a Los Angeles–based compensation consulting firm that serves compensation committees at public companies and has extensive experience helping clients demonstrate potential rewards to executives using the incentive-pay calculator. Both were formerly with Mercer Human Resource Consulting through its acquisition of SCA Consulting. Masuda holds an M.B.A. from the Wharton School at the University of Pennsylvania. Schroeder has an M.B.A.from the UCLA Anderson School of Management.

Topic tags: board of directors, compensation committee, corporate goverance