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Annual Cash Incentives for Managerial and Professional Employees

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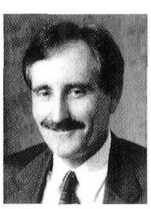

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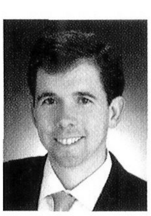

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ince the early 80's, there has been a substantial increase in the use of variable pay as a percentage of total pay that managers and professionals receive. In recent years, management's mantra has been to increase the "leverage" of variable pay to better align managers and professionals with the business, to encourage outstanding performance, to share the risk of business success and to more fairly reward those employees who make the largest contributions. With the exception of executive compensation, few research studies have attempted to link annual cash incentive pay programs to organizational effectiveness. Lack of empirical evidence, however, has not prevented compensation managers, academicians and consultants from suggesting that organizations can gain a competitive advantage by using variable pay to increase performance. Since annual cash incentives are widely used with managerial and professional employees, it would be in management's best interests to learn which designs of annual cash variable pay programs are most effective. Consequently, this study attempts to identify the most common design features of annual cash variable pay programs and determine if certain design features are more effective then others in driving organizational performance.

Research Methods

Identifying the Research Population

The first phase of the study focused on identifying the common features of annual variable pay programs in use today by reviewing the literature and discussing this issue informally with academics, consultants and practitioners. Differences in terminology and program definitions used in the compensation field created a significant challenge to the research. To meet this challenge, the team tried to find the most common or universally used terminology and definitions for policies or programs to minimize confusion for respondents.

The research team also recognized that there are variations in variable pay programs across different organizational levels and occupations within the same organization. For example, outside sales incentive programs are designed very differently than incentive programs for managers in a manufacturing operation. Consequently, research focused on managerial and professional employees for four reasons. First, most organizations tend to have a uniform set of policies and practices for this group. Incentive plans associated with the senior executive team or sales professionals were excluded from the study because incentive programs are often customized for these groups and even for individuals within these groups. Second, compensation managers will likely have substantial knowledge of the variable pay policies and programs for professional and managerial employees since they are typically accountable for program administration and are probably included in this group for pay purposes. Third, this employee group tends to have a significant impact on total organizational performance, making this a critical group to understand in terms of pay policies and programs and organizational effectiveness. Finally, the focus of the study provided continuity since managers and professionals were the focus of our previous study that examined the linkages between base-pay policies and practices and organizational effectiveness.

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Developing the Survey Instrument

In phase two, the team constructed a data collection instrument with statements and response categories that generated a set of standardized responses for use in quantitative analysis of the data. To enhance the richness of the findings, open-ended questions were also included to ensure that nonstandardized responses were captured. There were three cycles of pilot tests with compensation managers, consultants and academics before the survey instrument was finalized.

The final version of the survey instrument asked participants to describe and evaluate the annual variable pay program for which their managerial and professional employees were eligible as it related to:

Design features of the annual cash incentive pay program

Identification of those involved in program design

Administration and implementation

Evaluation of program effectiveness.

The study did not examine equity pay programs because a long-drawn-out survey might have discouraged compensation managers from responding.

Defining "Success"

We used three measures to determine the effectiveness of the annual variable compensation program. First, the team compared the pay policies and programs between companies included in *Fortune* magazine's 2003 "America's Most Admired Companies" list for their industry sector and those that did not receive the designation. *Fortune's* "Most Admired Companies" is a highly regarded annual survey of corporate reputations, conducted by Hay Group, of more than 10,000 executives, directors and analysts. The survey invites them to rate companies overall and within industry groupings on eight criteria ranging from financial soundness and use of corporate assets to quality of management, products and services.

Second, the team collected 2003 total shareholder return (TSR) information for the publicly traded companies that responded to this survey. TSR is defined as the monthly percentage growth in stock price and dividends paid over a five-year period. The team divided the TSR data into quartiles and compared survey responses for the highest TSR quartile (i.e., the top 25 percent of companies) with data from companies in the lowest or bottom quartile of TSR (i.e., the lowest 25 percent of the companies).

Finally, survey respondents were asked to make a personal assessment of the effectiveness of their compensation policies and practices. Although this measure may be subjective, we believe that the education and experience of most compensation managers provides a relatively valid indicator of program success.

Response Rate

A representative sample of more than 9,000 WorldatWork members was sent a Web link to the electronic survey instrument in late November 2003. The membership sample targeted the highest-level compensation manager for each company. Virtually all responses were from compensation professionals or HR managers who had significant responsibility for compensation decisions. During a two-week period, a total of 958 members responded. This represents variable pay programs covering approximately 2.8 million management and professional plan participants from a cross section of industries including manufacturing (26 percent), financial and insurance (22 percent), information (seven percent), health care and social assistance (seven percent), utilities (seven percent) and professional, scientific and technical services (five percent).

Key descriptive findings are highlighted in the following section. Additional relevant descriptive statistics are provided in this report's appendix. All percentages are rounded up from .5 and therefore may not equal 100 percent.

More than 99 percent of respondents completed the entire survey and were included in the analysis. Figures 1, 2 and 3 show how the sample represented virtually all industries and organization sizes. The analyses reported here are descriptive statistics and t-tests comparing responses between "Most Admired" and other companies, and comparing companies with the highest TSR (i.e., top quartile) and the lowest TSR (i.e., bottom quartile).

Research Findings

Program Features

Over the past two decades, the prevalence of variable pay programs has increased substantially and today a significant majority of organizations offer these programs. Seventy percent of respondents believed that variable pay was "important to very important" to the success of their organizations' competitive strategies.

FIGURE 1 Program Type and Eligibility

Type of Variable Pay Program	% of Managers and Professionals Eligible	% Responded Strongly to Moderately Effective
Individual-based Performance Programs	79%	89%
Team-based Performance Programs	48%	83%
Gain-sharing Programs	19%	72%
Profit or Revenue Sharing Programs	46%	69%
Equity Programs	59%	68%
Spot/Other Cash-based Recognition Programs	75%	70%

FIGURE 2 Types of Measures Used to Determine Performance

Annual (or short-term) Variable Pay	% Used
Individual measures only	25%
Group measures	75%

Individual measures only	25%
Corporate measures only	31%
Business unit, team, department measures only	16%
Combination of corporate, business unit and individual measures	15%
Other combinations	13%

FIGURE 3 Program Objectives

Primary Objectives of Variable Pay Program (Respondents asked to select three most important)	Percentage
Improve organization or team financial performance	65%
Create a more competitive total compensation market position	58%
Improve individual performance or productivity	47%
Improve overall productivity	32%
Better recognize employee contributions	32%
Promote a sense of ownership	22%
Use variable pay to better manage compensation costs	17%
Improve employee involvement	12%
Support culture change	8%
Reduce employee turnover	7%

Furthermore, 36 percent believed that it is "moderately important" for "most" employee groups and 44 percent believed that variable pay is "important" for "all" employee groups.

Data shown in Figure 1 excludes organizations that do not offer variable pay eligibility to both managers and professionals. However, 14 percent of this sample grants eligibility to "managers only" (not including the senior executive team), while less than one percent grants "only to professional" employees. Specifically, Figure 1 details the types of variable pay programs for which managers and professionals are eligible and rates the effectiveness of those programs.

Figure 2 indicates the types of measures used to determine performance. A majority of organizations in the survey (75 percent) utilize some form of group measure in variable pay plan design and 25 percent of organizations rely on individual performance measures alone to determine payouts. Of the organizations using group measures, a significant subset uses corporate performance measures only (31 percent).

When asked their view regarding leverage (i.e., variable pay as percentage of base pay), 73 percent of compensation managers believed that their managerial and professional employees were "moderately to aggressively leveraged" as compared to other companies in the labor market. As might be expected, higher paid professionals and managerial employees are more highly leveraged than those who are paid less. The range of reported variable pay (as a percentage of base) is provided below:

Paid less than $50,000 are leveraged zero to nine percent

$50,000 to $99,000 are leveraged 10 to 24 percent

$100,000 to $149,000 are leveraged 10 to 39 percent

$150,000 to $199,000 are leveraged 10 to 59 percent

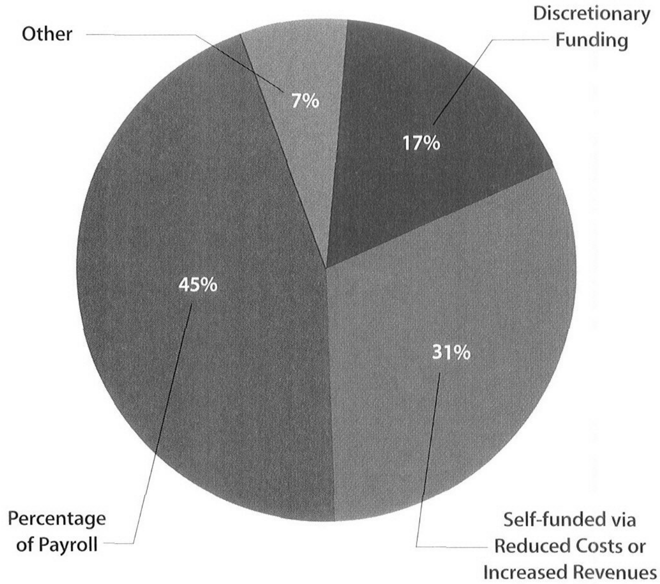
$200,000 to $299,000 are leveraged 40 to 79 percent.

Survey participants reported diverse reasons for providing variable pay programs to managerial and professional employees. Figure 3 indicates the number of respondents who said a particular objective was one of their top three objectives for the variable pay programs. "Improve organization or team financial performance," "create a more competitive compensation market position" and "improve individual performance" are the most frequently mentioned variable pay objectives. Improved overall productivity and employee recognition are in the second tier of objectives.

Three primary funding sources for the managerial and professional annual or short-term variable plans were identified, as shown in Figure 4, (i.e., discretionary, percentage of payroll and self-funded.) Discretionary is defined as a means of funding in which, near the end

FIGURE 4 Funding Sources of Variable Pay Programs

For Managerial and Professional Employees



of the performance period, the senior managers simply determine what the bonus pool will be and establish some method for dividing up the pool (i.e. the amount paid out is at the management's discretion). It was interesting that almost half (45 percent) of the managerial and professional annual incentives were simply budgeted as labor costs as opposed to self-funded plans (31percent).

Organizations tend to provide corporate safeguards in the design of variable pay programs. The survey indicated that 82 percent of variable pay programs have a hurdle or trigger that can cancel a payout and 87 percent of programs have pre-established performance levels. Likewise, most organizations have a maximum cap on earning opportunities in the variable pay program. Approximately 80 percent of those surveyed utilize a performance cap on potential variable pay earnings. Figure 5 shows that most caps are between 1.5 and 2 times the target.

It should be noted that nearly one quarter of plans have a maximum that is between 100 and 124 percent of the target. Our experience tells us that these are likely to be plans based on a hurdle. In other words, there is a specific objective to achieve and once the objective is achieved, there is a payout. Conversely, there is no payout if the objective is not achieved and there is no increased payout if results beyond the objective were achieved.

Figure 6 shows that the vast majority of variable pay programs for managerial and professional employees are paid annually.

Program Communications and Implementation

The survey indicates that 81 percent of the variable pay programs have been revised in the "last five years" with 47 percent revised during the "last two years." The primary designer of the variable pay plan for 66 percent of the respondents was "Human Resources," often with input from senior management. It is interesting to note that 23 percent of responding organizations "seldom involved eligible employees" in the design of the program.

Sixty-seven percent of compensation managers believe that "most to all eligible employees" understand the variable pay program.

Ninety-three percent of respondents indicated that they provided some variable pay communication. The findings report in Figure 7 on page 12 indicates that variable pay plans are communicated in diverse ways. "One-on-one discussions with supervisors" and "written materials outlining the plan" were listed as the primary means to communicate changes in the plan to employees. This indicated to us that executives use traditional, reliable and perhaps the most effective forms of communication.

FIGURE 5 Percentage of Target

If Plan Contains a Cap, the Maximum % of the Target	Percentage
100 – 124%	24%
125 – 149%	12%
150 – 199%	27%
200 – 249%	25%
250 – 300%	3%
Over 300%	1%
Not applicable	8%

FIGURE 6 When Programs are Paid Out

Primary Variable Pay Program Designed to Pay Out:	Percentage Responses
Annually	81%
Semi-annually	5%
Quarterly	7%
Monthly	1%
Achievement of objectives/milestones	2%

FIGURE 7 **Communication Vehicles**

Details and Updates are Communicated Through:	Percentage Responses
One-on-one discussions with supervisor	55%
Written materials outlining plan	52%
Information posted in a public place or on the intranet	31%
Employee meetings	34%
Variable pay information in NOT communicated	7%

Variable Pay Program Effectiveness

Compensation managers were asked to rate the effectiveness of their variable pay program for managers and professional employees on several dimensions. Figure 8 shows the percentage of managers that said that the variable pay plan was effective or very effective for the stated dimension. Figure 8 indicates that approximately two thirds of compensation managers are satisfied with the overall effectiveness of their variable pay programs. However, this still indicates that a significant minority (one in three) is not satisfied. The items that scored higher on perceived effectiveness tend to be design-related attributes such as frequency of payouts, funding mechanism and appropriateness of measures. The relationship between payouts and organization performance also scored high, but the relationship of payouts to individual performance and team/group performance scored lower. The motivational value of the program also scored relatively low. We could imply that since a high percentage of plans are based on corporate measures only, the motivational impact at the individual level is diluted.

The criteria used to judge the effectiveness of managerial and professional annual or short-term variable pay programs are shown in Figure 9.

FIGURE 8 **Effectiveness of Programs**

Variable Pay Program Dimension	Percent Responded Effective to Very Effective
Frequency of payouts	79%
Funding mechanism	77%
Relationship between variable pay program payouts to organizational performance	72%
Appropriateness of the variable payplan measures	68%
Overall effectiveness	64%
Administrative ease	64%
Appropriate return on investment	62%
Employee understanding the program	61%
Motivational value of the program	55%
Relationship between variable pay program payouts to individual performance	53%
Responsiveness to change	50%
Relationship between variable pay program payouts to group or team performance	43%

FIGURE 9 **Criteria Used to Judge Effectiveness**

Criteria Management Uses to Judge Effectiveness of Their Programs (Respondents asked to select all that apply)	Percent Response
Business operating results	73%
Informal opinion gathering from senior leadership	35%
Employee satisfaction survey measures	30%
Employee productivity metrics	28%
Employee turnover or retention	27%
Informal opinion gathering from employees	23%
Management does not evaluate variable pay plan success	16%
Labor costs are controlled or lowered	9%

Respondents indicated that "business operating results" are the primary criteria, with "informal opinion gathering from senior leadership" a distant second choice. This same question was asked in last year's survey regarding base pay practices. For base pay, respondents overwhelmingly chose employee retention as the primary effectiveness criterion. This shows that HR professionals are taking a balanced approach to compensation and using different compensation vehicles to meet different objectives. Base pay tends to be used to attract and retain talent and variable pay is typically used to reward performance.

Interviews with compensation managers supported these trends. Companies that were successful with variable pay attributed it to line of sight and communication. Mark Premock, general director of compensation at Burlington Northern Santa Fe, said during a personal interview on April 29, 2004, "We take extra time to get performance communication approved by the entire senior leadership team. That way, no matter how employees receive their information, it is always a consistent message."

Compensation managers indicate that improving the "line-of-sight"and the linkage between payout and performance are the most important ways to improve the variable pay programs. (See Figure 10). Despite these findings, a majority of organizations do not involve employees in the design of the variable pay program. This seems to be an obvious area for improvement. In focusing on line-of-sight issues, organizations are suggesting that they must do a better job of ensuring that their employees understand what they are being asked to do to earn their rewards, and that their individual goals are based on a realistic view of the future and connected to what the organization needs to succeed in the future.

Employees are typically motivated to provide additional discretionary effort in their jobs when they feel connected to the bigger picture and understand

FIGURE 10 Areas for Improvement

How Variable Pay Programs Can Be Improved (Respondents asked to select three most important)	Percent Response
Improve plan "line of sight" to individual or team efforts	60%
Improve linkage between payout and performance	57%
Improve communication of plan objectives	48%
Increase understanding of the variable pay plan	33%
Improve ease of administration	23%
Increase payout opportunities	23%
Ensure goals are viewed as more attainable	22%
Reduce conflicting goals	9%

how their actions contribute. This is both a variable pay issue as well as a communication issue. Goals and measures will have little value if employees are unaware of how they are progressing toward the goal until they have either met or missed it.

Conclusions

In this research, we have seen that the prevalence and eligibility levels of variable pay programs are substantial and that compensation professionals view variable pay programs as instrumental in their reward strategy. The primary objectives of these programs tend to be squarely focused on improving organizational and individual performance and improving the overall market competitiveness of pay. The majority of plans consist of group measures, but there is renewed focus on individual measures.

This study indicates that variable compensation for most managerial and professional employees is still administered under fairly traditional, time-tested methods such as individual bonuses, profit sharing, gain sharing and equity programs. Compensation professionals believe that these methods are generally effective, as is evident by their widespread use and positive responses regarding the perceived effectiveness of these programs. Designs for short-term or annual cash variable pay programs are generally given high ratings for effectiveness by the survey respondents, but program implementation is not viewed as favorably. Relatively low marks are given for the effectiveness of the compensation programs' motivational value and communication to employees. Although individual variable pay plans are rated highly, most plans have a group variable pay component. We have found in this research that there were not many differentiating features in terms of plan design, but that programs differ widely in terms of how they are executed — especially in the areas of communication, building line of sight and providing management with an important role in the design and implementation of these programs.

Compared to our previous study that examined base-pay issues, we found fewer connections between program design features and two measures of organizational effectiveness, i.e., TSR and designation as a Most Admired Company (according to *Fortune* magazine). We did find that the most admired companies were more likely to involve program eligible employees in the design of the variable pay program. Involvement not only builds commitment to the program, it may also improve program design and help employees better understand how the program works.

Compensation managers from most admired companies perceived their annual cash variable pay program as being more effective, especially as it related to the motivational value of the program and the relationship of variable compensation payouts to individual employee performance. Respondents from most admired companies also had more confidence that employees understood the program, which is consistent with their willingness to involve employees in the design of the program. The authors did not find any significant differences between variable pay program design features and TSR.

Thus, we conclude that annual bonuses for managerial and professional employees will continue to be an important component of their pay. However, program effectiveness is less an issue of having the "right" program features and more dependent on program implementation and communication. Therefore, companies that want to improve the effectives of their annual incentive programs should focus on helping employees understand the program and how their actions contribute to business results, and on building commitment for the program. WJ

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Prior to joining Hay, McMullen was in senior compensation roles with Kentucky Fried Chicken Corp. and Humana Inc. He holds a master's degree in business administration and a bachelor's degree in mathematics from the University of Louisville.