Evaluating compensation strategy and incentive plans

1. 1. 0 Introduction

It has become more and more important, especially in the current conditions following the credit crunch for organisation to monitor and control labour costs, whilst striving for increased productivity, better quality and good customer service.

For this reason; there has been need to review strategies, if not bring in new strategies towards employee compensation and incentive schemes.

In this competitive environment, companies are looking to recruit and retain high performing and highly committed employees and taking note that this comes at a cost, but a cost justifiable enough to ensure competitive advantage and success of the organisation.

“ Michael H. Schuster, P. H. D on Aligning Compensation Strategy” notes that “ Companies are examining the method and basis for compensating employees, there has been a growth in the number of companies seeking to develop high performance, high committed work systems, based upon expanded roles for employees, require that employees accept more responsibility and accountability”.

Therefore employee compensation is an important element to the financial success of the organisation. A strong emphasis is placed on the fact that compensation and reward schemes should transparently reflect the financial potential of the company and align it to the organisation strategy and objectives.

In the past, wages and salaries usually grew only by a consistent and constant spinal point. More recently, there has been a growth where the labour market has become more and more aggressive and has brought about the notion that compensation and incentive packages must be competitive enough to attract and retain well skilled workers.

2. 1. 0 Compensation Strategy

As all strategies for any organisation, the ultimate goal and objective is to maximise the wealth for shareholders. The compensation strategy should take into consideration that;

They should clearly implement a value based company management system.

The long term appreciation and capital value of the company

Market conditions and orientation of engaging qualified and skilled workers

And important aspect is the cost of the strategy to the organisation.

Compensation is one of the main concerns to secure the high performance of the organisation. There is no understatement in saying that organisations perform because of the work being carried out and accomplished by the people it employees, and therefore they make the difference. In saying this, it is important to note that protecting human capital is crucial, and this is done through motivation, recognition, an appropriate reward and compensation scheme.

An obvious and important element to consider in the strategy is the possible analysis of the cost of executive and employee compensation will cost the organisation. This will be concentrated on the opportunity cost to the company of the stock and performance based parts. The cost in this case to the company would therefore be the foregone resources on the compensation agreement.

“ It is said that money is a powerful source of motivation. But it’s also said that salary increase can only motivate until the next pay increase is due.”

An element of any organisation’s compensation strategy is to always reflect the strategic business objectives. The objectives and goals should be clearly defined, making them achievable through the compensation structure.

As stated earlier and reemphasised now, the compensation plan should be integrated with the performance objectives of the organisation and with the employee’s individual’s goals.

2. 1. 1 Core Elements of Compensation Strategy

An intensive analysis needs to be carried out on the organisation framework, this will be able to establish and reflect the demands of the future business development and which framework conditions will be required to structure an effective compensation strategy.

It is even more important to define the management and operative levels taking into account value orientation. As well as the objectives that have been set out for each employee and how their performance is evaluated.

Therefore clear roles and responsibilities need to be defined and a strong communication system to be put in place to ensure that all employees are aware and know how their performance is reflected into the incentive scheme.

Other elements to consider are should be;

Generic

They should be a buy in into the incentive plan by the employees. It should be designed in such a way that employees at all levels are participative and have the same gaol and direction.

Be of significant and Perceived Value to the employee.

Employees should be able to easily recognise the potential reward related to performance.

Related to Individual Performance

As stated by Bob Normand Institute of Smart Business Management. “ A factor in the determination of how much an individual employee receives should be their performance rating as determined by their formal job review and appraisal.

Employee Loyalty

A good incentive plan should be able to retain employees and gain their loyalty. Therefore, an incentive plan should foster employee tenure and performance.

There are two main streams of rewards being monetary and non monetary. The monetary being the preferred, and is usually a Pay-For-Performance scheme. Types of performance based pay are;

Stock based – This will include stock options and grants, equity shares.

Cash Compensation – These are usually bonuses and are related to the achievement of performance objectives and goals that were set out. Cash incentive is the most common and preferred form of an incentive scheme.

An effective compensation strategy if implemented successfully can fulfil other objectives. This has been summarised in the table below;

Objective

Result

1. Alignment to the strategy of business units.
2. Strong market position.
3. Strengthens the performance and is result oriented.
4. Competitive Advantage
5. Enable organisation change and flexibility to adapt to changed business situation.
6. Success and forward moving organisation.
7. Promotes motivation and loyalty
8. Retaining of highly skilled employees.

Controversy Over incentive schemes

1Over the past years, and more recently the past 2 years, where the economy experienced a depression and a down turn in the market for most industries, there have been continued sensitive arguments over corporate executives' compensation and how they align to the firm's performance. " Holmstrom 1979,[2]looked at the contribution that made clear the trade off between risk and incentives in the moral hazard problem." This study was partly based on his unpublished dissertation.

The media, public, politicians have raised concerns over the current executives compensation packages that seem to drive employees towards taking short term risks, without taking into consideration the long term repercussions and effects on their organisation.

As a result of this, there have been regulations being put on the table that look at restricted stock pay options and maximum level cash incentive, or other types of compensation that will focus more on long term performance. This will push executives to always base their investment and finance decisions with the shareholder's best interest at hand. There will have to be a strong correlation between long term incentive compensation and the future firm performance.

With the emphasis on transparency, CEO's pay is usually publicized in the press in papers and magazines such as Fortune Magazine that has an annual ranking of the highest paid CEOs. It has been observed that the firms that pay their CEO's the highest are organisations that tend to be the ones experiencing high returns, and high operating performance in comparison to others.

4. 1. 0 Performance Measurement and Incentive Schemes

Leonard, 1990 and Hayes and Schaejar 2000, looked at the studies that focussed on the relationship between pay and the future accountancy performance of the organisation.

There has been an assumption that in efficient markets, executives and investors will capitalise the present value of future firm performance increase into the stock price.

The question is always 2 how do you align strategic performance measures and results to compensation and incentive plans?”.

“ The first question to ask when designing a bonus plan that replicates the incentive of an owner is how to measure business performance. The right measure of corporate performance will have strong ties to the amount of additional wealth that a company produces for its shareholders and by extension for society at large. It will guide people to make the decisions that will generate the added value necessary to fund their bonus, to re w a rd the shareholders and to reinvest in business growth.”

They are several models that organisations can use to measure the performance and determine the level of incentive to be paid out to executives and employees.

Strategic Performance Measurement (SPM) System – This measurement translates the business strategies and objectives into deliverable results. The advantage of this model is that it combines the financial, strategic and operating measures and compares it against how well an organisation meets its objectives, goals and the targets.

Economic Value Added (EVA) / Value Based Management – This model emphasises on performance measurement and the cost of capital and measures the value created for shareholders. The main advantage of this measure is that its focus is on wealth creation.

Balanced Scorecard System – Its core element is its emphasis on the key business drivers such as customer and employee satisfaction, operational excellence and new product development.

4 As strongly supported by Stern and Co. Economic Value Added offers more to an organisation as it focuses on measuring value created for shareholders, which is the essence and objective of any organisation; to create wealth for its shareholders. This measure is also focuses more towards the capital markets and assists in developing organisation strategies at all levels of the organisation.

5 Other advantages of EVA as a measurement tool are;

- It creates measurable objectives and goals for employees and are specific
- It can easily align the operations and business units with the overall corporate strategy.
- EVA can link individual performance and compensation plans to business strategies.

5. 1. 0 Relationship between Stock Price Performance and Incentive Schemes

The hypothesis by a paper written by " M. Cooper, H. Gulen and P. Ray – Performance for Pay?" looked at the relationship between CEO incentive compensation and future stock price performance.

They summarised that " The efficient market hypothesis suggested that markets capitalise incentive pay grants into the stock price at the announcement day, resulting in no relation between incentive pay and future stock price performance."

On the other hand, the optimal incentives hypothesis suggests that whilst compensation and incentive schemes can be aligned to managerial interests with shareholders value wealth creation and maximisation, investors may not necessarily react to the information. This could be as a result of not understanding the incentive strategy, and not having the right measurement model to gauge it against. Therefore investors are not able to observe or attain the value it may have to the organisation future stock price performance.[6]7A positive relation may be evaluated between the incentive pay and the future stock price performance.

8Needless to say, based on studies carried out in the past and present on the relationship between Stock Price Performance and Incentive Schemes, there is not much direct evidence that shows that incentive plans do lead to a company's improvement in future stock price performance. One of the challenges of stock returns are they having shareholder's expectations imbedded in them. Other challenges are that economic theory would not be able to predict that increase in incentives would lead to increase in profitability.

9 A much earlier study by Masson 1971 linking financial incentive to future performance of the organisation, his findings were that firms and organisation that had attractive financial incentives showed a better stock market performance during the post-war period.

Conclusion

Due to the increased competition of business, it has subsequently increased the competition for employing skilled workers, and retaining them.

A compensation strategy creates and brings about a unified culture, and offers corporation and advances the implementation of the business strategy. This will essentially promote performance and employees will be result oriented.

Incentive plans should be reviewed annually to analyse if they are actually effective and increasing the performance of the organisation and meeting the strategic objectives. This involves looking at any accomplishments and the desired outcome.

“ Despite the soaring pay, many experts argue that the system is working better than ever. They see the bull market and healthy corporate sector as proof positive that companies get what they pay for. (Business Week April 21, 1997, p. p 60)

Performance based pay is the best incentive strategy for any organisation as it maximises on the strategic plan, as the compensation strategy requires that the plan is set on organisation goals and objectives. This has a major influence on the employees. Pay for performance has been cited to be a more motivating factor, both short term and long term incentives.[10]A study carried out established that employees showed a more positive work attitude with a pay for performance incentive. Other benefits of a pay for performance incentive scheme is the pay receives special treatment in some contexts. This is under the Internal Revenue Code (IRC).

Essentially, at the end of it all, the compensation strategy and incentive plan’s main purpose is to:

- Attract and retain employees.
- Motivate and establish loyalty towards the company.
- Making sure the cost of the strategy is line.
- Encourage peak performance.