Analysis of incentive program for employee retention

Structure of report

– Introduction (A brief introduction of the company's overall performance and the purpose of current incentive plan)

– Analysis of current incentive plan

– The benefit and cost of current incentive plan

– The improvement of incentive plan (Arguments)

– Conclusion

Introduction:

Superconductor Technologies, Inc. (STI) was a technological company advanced in developing, manufacturing and marketing high-temperature superconductivity (HTS) products for wireless communication networks. It owned unique technologies, software design and simulation tools, such as the patented thin-film technologies, as well as having more than 3, 000 STI system around the world. STI had established itself as the clear leader in the HTS wireless network optimisation technology marketplace.

However, STI's did not replicate its success in technology logical development to its financial performance. STI had never made a profit in its entire 17 years of operation, even though STI revenue had grown rapidly since 2001. Due to continuous loss over the past 17 years, STI was worried about its employees resigning, because of the unattractive compensation and incentive systems. In addition, management of STI was also concerned about the agency problem between managers and shareholders, on the incentive system motivating behaviours that is not in the best interests of the shareholders. Therefore, it is necessary to evaluate the potential benefits and costs of the existing incentive system and suggest changes to it. This would not only help STI to make profit for the first time, but also improve its employee retention.

The Current Incentive system (Benefits and Costs):

The current incentive system of STI is made up of 3 schemes respectively: The base salary, cash bonuses and stock options. All 3 schemes have their own benefits and costs.

The base salary is a simple plan targeted for most of the employees including the top executives. They will be receiving a competitive salary with an annual increase up to 5%. The benefit of this is that the employees will be more engaged to work for STI, instead of its competitors. This allows STI to not only attract new employees with better quality, but also captivate existing employees to stay and hence this will improve employee retention. With improved employee retention, there is less need to re-staff employees, meaning that this avoids additional cost burden from the hiring process, which take up many resources. Examples of these are cost and time for posting an advertisement, screening candidates' application, interview and training etc.

However, promoting a competitive base salary will definitely be contributed as a large financial burden especially to STI, which had never made a profit in its entire 17 years of operation. Since handing out a competitive salary with an annual increase is not a one-off payment, it is an annuity that can continue for a long period of time, until the employees retired or are fired. In addition, placing too much emphasis on monetary incentives, like competitive base salary, may neglect other form of motivation. It is undeniable that an attractive salary can win over qualified employees, but over time, other form of incentives are better to motivate enhanced performance. Example of these are implementing a training and development programme, permitting higher responsibility and autonomy among its employees’ etc.

The Cash bonus scheme at STI, according to its performance on the corporate and individual objectives, is a bonus plan which awards cash to top executives of STI. Top executives will be able to receive 25% to 40% of their base salary. The benefit of establishing cash bonuses scheme is that the company is recognising the effort of its employees, by encouraging and rewarding them for phenomenal performance. Not only does this benefit STI in terms of the attributes from the performance scorecard, but it also improves employees’ individual performance. In addition, cash bonuses are a one-off payment only for top executives, therefore, this scheme is a relatively more flexible incentive measures compared with competitive base salary.

Despite the above benefits, however, cash bonuses also have their own costs. They are measured by both corporate and individual performances, allocated by 75% and 25% respectively. However, the performance measurement is not significantly related to gaining profit or adding value to the company. Instead, it places most of its focus in to sales (revenue growth). This is one of the reasons why STI still has not made a profit.

According to Ken Berry, VP-Human Resources and Environmental Health & Safety, top executives can still receive very high amount of cash bonus even if they " didn't earn as much profit as we'd expect" (Merchant and Van der Stede, 2017).

Shortcomings and solutions for the Current incentive system of STI

In this section of the report, a detailed overview of the problems associated with the current incentive system will be given. In addition, potential solutions will be given for each problem, which will help STI perform better long-term.

Restricted stock

One of the issues present within STI's current incentive system was the ' underwater' options (Define what you mean by underwater options). Most of the options lost its practical value since 2012 due to the poor stock performance, which is a counteraction of the incentive plan. Moreover, the disparate number of stock options granted to its employees, especially the top executives, may also affect the stock price and their stakeholders' interests significantly in the long term. Once a large amount of options are issued, it lowers the stock price, which will then dilute the future potential earnings per share of existing STI's shareholders.

To solve these problems, STI may issue restricted stock units, to replace its current stock options plan. A restricted stock unit is typical of an incentive plan that grant company shares to valuable employee at a fair market value under various restrictions (Reference needed). The restrictions are subject to a vesting schedule that based on the established requirements of performance milestone or length of employment. Besides that, the employee can choose whether to receive the company's shares or the cash equivalent of the number of shares once he reaches the vesting date.

However, these granted stocks carry no voting and dividend rights until the employee satisfies the vesting requirements within the vesting period. If the employee fail to compliance with the company's criteria before the end of vesting period, the employee's granted units are forfeited to the company. Hence, the restricted stock unit is an acknowledged tool to hire and retain highly talented employees, as they are likely to stay until the additional stock units are fully vested.

Grants of restricted stock units can solve the current problem of ' underwater' options since they offer the stock to the employees at the fair market value on the vesting date. Therefore, the variation of stock price will not affect the validity of the reward. Also, options have a stated expiration date, but the restricted stock units are converted to shares when they are fully vested, which have no expiration date. Nonetheless, the restricted stock units are taxed as ordinary income once they become vested.

One of the issues present within STI's current incentive system was the disparate number of stock options granted to its employees. Whilst employees in the top management board received thousands of options annually, roughly only 200 options per year were granted to employees working in lower levels of the organisation. The large number of stock options granted to the top executives can cause issues for the organisation.

They can take actions in terms of affecting short term stock price, which can create detrimental effects for long term shareholder value. For example, they can make actions which cause the stock price to increase or decrease within periods of stock option grant or exercise. This can effectively make stocks in the money, or lead to larger payouts when exercising, when spread out across a large number of stock options. As payout from stock options are significantly impacted by the actions of management, this can lead to them placing greater focus on the short term incentives of pay rather than the long term incentives of shareholder value.

To solve this problem, the company can issue restricted stock options. This is a popular form of stock option issues to top-level management, which is often used as a form of employee compensation. It becomes transferable upon the satisfaction of certain conditions, such as continued employment for a period of time or the achievement of particular product-development milestones, earnings per share (EPS) goals, or various other financial targets (Chen, 2018). In this case, the top level management will not receive large volumes of stock options relative to employees due to their position in the company. Instead, they will also more likely receive the options based also on their ability to meet company targets.

Secondly, as STI has been struggling to make any financial profit, it would be useful for the company to reduce some of its current expenses.

References

- Merchant, K. and Van der Stede, W. (2017). *Management control systems* . 4th ed. New York: Pearson Education Limited.

- Chen, J. (2018). *Restricted Stock* . [online] Investopedia. Available at: https://www. investopedia. com/terms/r/restrictedstock. asp [Accessed 1 Jan. 2019].