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Executive Summary

Executive Compensation Strategies

Question

What are the most effective executive compensation strategies for those levels not eligible for long term incentives but who are looking for more than a traditional fixed and variable pay program?

Introduction

The trend toward incentive-based, long-term compensation has increasingly strengthened as companies seek to align shareholder, management, and executive interests, especially in light of the financial crisis of 2008[i]. Privately held companies face a unique challenge because they are not in a position to easily offer stock options as a means of a long-term incentive plan; although possible, it is both cumbersome and dilutes the owners' control of the company. We have identified two alternative means of providing incentives to managers and executives: deferred compensation and the use of perquisites. In addition, we provide a closer at look at the impact and efficacy of the trend toward incentive-based pay on employee and business performance.

Key Consideration: *Does Executive Pay Really Work?*

A 2012 study by PwC and the London School of Economics of 1,106 executives from 43 countries provides interesting insight into the effectiveness of long-term incentive-based compensation plans (LTIPs). The key findings from the study are as follows:

- Executives discount the value of deferred pay by 50 percent, on average for the course of the deferral. This finding begs the question, are you really paying for performance if the award is de-valued by the executive so significantly? Moreover, these plans are typically more costly to the employer, with companies paying 10% more to award pay as a bonus[ii].

- Variation exists among executive demographic groups in terms of how they view risk, recognition, and perceptions of pay fairness, so flexibility in pay programs is essential for success. Research suggests the role of the executive is important, too. For example, for sales executives, some research suggests that as profit margins and sales fluctuate over the life cycle of a product, so too should the compensation strategy. BI should consider aligning the Variable & Performance-Related Reward (VPR) component with the various stages of the Product Life Cycle (PCL). While this study pertained to sales employees, it merits further consideration of how BI's compensation policies align with the timeline for Research Executives[iii].

- Despite the fact that less than 50% of executives view their LTIP as effective, two-thirds of the participants want to participate because of the status and recognition associated with the plans[iv]. One way for BI to respond to the finding that executives value LTIPs because of the recognition factor is to strategically use perquisites, as explored below in more detail.

Solution #1: Deferred Compensation Plans

Nonqualified deferred compensation plans (NQDC) are arrangements under which employers agree to compensate employees later for services performed now. Compensation is usually deferred for 3-5 years, although it may be until after an employee has ended employment or retired[v]. To be considered a NQDC plan, the plan must meet certain criteria: the employee must not be in constructive receipt of the amount promised (no right to accept or decline benefit), the employee does not receive an economic benefit from the compensation (for example, use as security for a loan), and a substantial risk of forfeiture must exist as executive's ownership is contingent upon meeting certain conditions or goals[vi].
A NQDC plan can be created for an individual, or offered to a specific class of employees. This flexibility permits the employer to tailor criteria for awarding the deferred compensation to fit the strategic goals. Criteria may be tied to performance, such as reducing cost or increasing profit by a predetermined amount, or may be less specific, such as a non-compete clause.

Advantages to Employer:

- Flexibility in plan design, including ability to establish specific criteria
- No need to fund plan until payment is actually made, freeing capital for other priorities
- Advanced knowledge of exact value of benefit

Advantages to Employee:

- Ability to defer compensation reduces tax liability
- Predictability of benefits
- Ability to determine timing of payment of benefits
- Advance knowledge of exact value of benefit
- Timeline is variable, so employee has ability to determine length of deferral. The timeline can be rather short, or can be tailored to a specific goal (for example, purchasing a new home or funding college expenses).

Solution #2: Reconsider perquisites as an incentive and competitive strategy

- We note that benefits are already a component to BI's total compensation approach, however we take a closer look at their efficacy and new forms of use. According to a study by Equilar, 2012 CEO perks packages rose 18.7 percent in 2012[1], despite increased scrutiny from shareholders and the media. While BI is not subject to say-on-pay votes, this trend is important for benchmarking as well as understanding the important motivating role that perquisites can play. Perquisites are "privileges granted to employees in addition to their salaries and benefits, which make the job more enjoyable for an employee." Recently, companies are expanding the scope of perks from company cars and vacations to include ways to allow employees to customize their employment arrangement. Unlike health benefits, for example, perks are most effective when they are perceived to be scarce and when Management has discretion over how they are allocated[vii]. For example, with their "Blue Sky" program, Apple is following Google's path of allowing employees to spend time on an innovative project of their choosing. The use of this type of perk is powerful in that it places importance on intrinsic work values, increases employee loyalty, and serves as a form of recognition for key executive talent[viii]. BI's corporate values state "Value Through Innovation", thus the compensation

[1] Data for non-CEO Executive perks packages was not available, but we have included the CEO statistic to illustrate a current trend.

plans should be structured around encouraging innovation, with the right balance between risk, rewards, and autonomy[ixx].

Employee values and their generational cohort should be considered when designing pay programs:

- It is critical to understand the employee's perspective and values when designing compensation plans. Work values have been defined as, "the outcomes people desire and feel they should attain through work", which influence an employee's attitude, behavior, career decisions, and problem solving ability. Research suggests that Generation X employees consider intrinsic work values: the learning opportunity, opportunity to be creative, and process of work to be more important than extrinsic work values, which include the consequences or outcomes of work, such as income, status, and job advancement opportunities. Accordingly, strategies used to attract and retain executives should include the opportunity for increased autonomy, decision-making, and career development. Surprisingly, increased job satisfaction is so important that US executives were found to be willing to give up pay for fulfillment by accepting a 35% pay cut[xi]. It is important to note, however, that employee work values differ among generations, so BI should contemplate different strategies for recruiting and retaining different generations of workers[xii].

Conclusion

Although privately-held companies face additional challenges to offer competitive compensation, there are alternative means to achieve this. Deferred compensation and perquisites, when used strategically, can serve to incentivize employees and to enhance a competitive total compensation package.

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