

Compensation Planning During an Economic Crisis

By Mark Reilly, 3C Compensation Consulting Consortium

Do You Have Answers When the CEO Comes Knocking?

Survey results published by *The Wall Street Journal* on Oct. 13, 2008, indicate companies expect earnings to be weak, bonuses to be low and most stock options granted in the past five years to be underwater.

As the news stations continue to paint a bleak picture, compensation committees, boards of directors and executives will be looking for answers to some difficult questions. As the compensation expert, you need to be prepared for tough questions and be in a position to communicate ways to control costs and ensure key talent doesn't jump ship.

While this matter is not easily solved, the advice in this article can at least arm you with some ideas, prepare you for questions and provoke further thought.

QUICK LOOK

- ➔ Compensation committees, boards of directors and executives will be looking for answers as sales decline and stock options remain underwater.
- ➔ To control fixed costs, consider limiting your salary increase budget to the company's sales growth rate, and hopefully reduce the need for layoffs.
- ➔ Motivate employees and conserve cash with a new stock option grant or with a cost-neutral underwater option exchange.



Quick changes to your compensation program in response to rapidly changing economic conditions can result in unintended consequences, such as windfall payouts, excessive turnover and negative accounting. And while it may be attractive to maintain the status quo and wait for the economy to stabilize, this also is not necessarily the best solution and could potentially cause further harm to a company and its employees. So what is the answer, and where do you start?

Base Salary

First, let's look at one of the basics in a compensation program: base salary. As a fixed cost, base salary typically remains the same, regardless of your level of sales. In a weakening economy it is important to keep your fixed costs as low as possible to offset flat or declining revenue. Base salary levels also impact benefits costs, such as retirement programs, which are often funded by employers on a percent of salary basis. How do you manage salaries in this economy and hold down salary costs? Here are a few possibilities to consider.

- 1. Set a budget for overall salary increases that is limited to the rate of the company's increase in sales.** If sales are flat or declining, there will be no salary increase because the economics of the business cannot support it. Although this is not something that will be popular with employees, it should be communicated as a measure to retain jobs and address the financial realities of a slowing economy. There are some downside risks to this policy, and they need to be weighed in relation to the economic challenges of your business. For example, if your competition increases salaries and you don't, you could lose some of your key employees, but this is probably a low risk due to rising unemployment.
- 2. Set a budget allowing for a modest salary increase** of 2 percent to 3 percent, but allocate 80 percent of the budget to the top 20 percent of the employees to retain key talent. In these tough economic times, paying for performance is even more important. The downside is that this is a difficult message for many employees to hear, and it could lead to negative employee morale and productivity.

- 3. Set a modest budget and allocate an across-the-board increase,** giving the same percent increase to everyone. Although the increase will be small, everyone will be treated the same, and this may help morale. This means suspending the traditional salary-increase matrix, used by many companies, that is based on a combination of performance rating and position within the salary grade range. Because of the limited salary increase budget, it will be difficult to provide a meaningful differentiation

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between strong and weak performers. This change may generate more "real" performance appraisals since they will be used for professional development rather than salary increases, whereas an upward bias in ratings often leads to most employees being rated above average.

Annual Incentives

Clearly, there has been an increase in pay for performance in the United States and the world. The WorldatWork Salary Budget Survey shows variable pay has grown in prevalence since the early 1990s, with 80 percent of responding companies currently offering at least one type of broad-based variable pay plan, compared with 51 percent in 1991. As base pay increases remain low for 2008 and 2009, companies continue to rely on variable pay — performance-related awards that must be re-earned each year — to attract, motivate and retain employees.

Successful variable pay programs must be a win-win for employers and employees. Employers use these programs to manage their compensation costs and drive business results; employees like variable pay programs that have a clear line of sight between their job activities and their bonus.

A successful variable pay program must have meaningful goals and be effectively communicated to employees. One reason to use incentive pay is to have fewer layoffs during a downturn, as compensation costs move in line with the performance of the business. If this is your policy, tell your employees what you are trying to do. To develop a program that is effective in a weak economy you should:

1. Make sure total company incentive payouts vary with total company performance, even though

a portion of incentive pay may be tied to individual performance goals. Calculate the ratio of total incentive pay to net income (or sales) and look at how this ratio tracks from year to year. After excluding extraordinary events, such as mergers or large write-offs, analyze the relationship between company performance and incentive pay. If total compensation costs do not vary with company performance, the incentive plan needs to change.

2. Communicate that the incentive program is not an entitlement

and that past payments or participation is not a guarantee of future participation. Set goals based on the probability of attainment — minimum goals should be met 80 percent of the time, target goals 50 percent to 60 percent, and maximum goals of 10 percent to 20 percent. Under this system, if your target bonus is met every year, the goals for your plan are too easy; your target goal and corresponding bonus should only be met 50 percent to 60 percent of the time.

3. Communicate to employees that compensation will vary with company performance and that will hopefully result in fewer layoffs.

Long-Term Incentives

The drop in stock prices has put many stock options underwater, and shareholders are not in a mood to rescue highly

paid executives. However, many companies are concerned about retaining their key talent, especially in service industries where people are the key assets. What would you do if most of your compensation was based on the company's stock price and the stock price just dropped 50 percent? Would you listen to offers from good companies with bargain basement stock options? Consider the following:

- Cash is king in a financial crisis, and it may be necessary for the company to conserve cash to survive when bank loans or other funding sources are not available. Consider using restricted stock or stock options as a replacement for some cash compensation.

Minimum goals

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- When the stock price is really low, forget using the Black-Scholes model to determine the size of stock option awards, because the model will require the company to use a large number of shares to reach the 50th percentile of the market (see Figure 1 on page 38). Instead, use a modified approach by starting with the amount of value to be delivered in the future — say five years — using historical growth projections. If the stock price recovers close to its 52-week trading high in the next five years, significant value will be delivered, without excessive shareholder dilution.
- Determine if an underwater option exchange makes sense and review the possible accounting implications (see Figure 2 on page 38). To determine the number of replacement options we calculate the value (in this case

using Black-Scholes is recommended) of the underwater options and determine how many new options or restricted shares equal the value of the underwater options. Although the Black-Scholes model is not effective for determining option grants when the stock price is very low, it is useful for determining a like-value exchange of underwater stock options. The replacement-option calculation is an accounting-driven application focused

FIGURE 1: BLACK SCHOLES VS. MODIFIED BLACK SCHOLES

Black-Scholes Model for Granting Stock Options

| | |
|---|-------------|
| Current salary | \$1,000,000 |
| 50 th percentile of market for long-term incentive grant | \$783,526 |
| Current stock price | \$20.00 |
| Black-Scholes value | \$6.00 |
| Stock options needed | 130,588 |

Modified Approach for Granting Stock Options

| | |
|---|-------------|
| Future value of \$783,526 in five years at 5% | \$1,000,000 |
| Current price | \$20.00 |
| 52-week high | \$60.00 |
| Difference | \$40.00 |
| Number of stock options required | 25,000 |
| Difference between standard and modified | 105,588 |


FIGURE 2: REPLACING UNDERWATER OPTIONS

| | Underwater | Replacement |
|---------------------------------------|--------------|-------------|
| Price today | \$100.00 | \$100.00 |
| Exercise price | \$300.00 | \$100.00 |
| Volatility | 30.0% | 30.0% |
| Risk-free rate of return | 3.0% | 3.0% |
| Typical holding period | 5 | 5 |
| Dividend yield | 1.0% | 1.0% |
| Black-Scholes value | \$3.0362 | \$28.5784 |
| Number of options outstanding | 5,000,000 | |
| Total value | \$15,180,917 | |
| Replacement options | | 531,203 |
| Replacement ratio | 1 | to 9.413 |
| Replace options with restricted stock | | 151,809 |

on the goal of cost neutrality. No additional charges to a company's earnings will be incurred as long as the fair value of the new award is no greater than the fair value of the surrendered underwater options. The exchange typically allows companies to significantly reduce their overhang levels.

Industries that rely heavily on stock and bonus compensation, such as technology and financial services, have been hit hard by the current economic downturn. If executives in these industries feel they cannot get some relief from their underwater stock options, corporations may find those executives more inclined to move to an organization that offers them options at today's bargain-basement prices.

Conclusion

This is a crucial time for organizations to review and revise their compensation programs in order to retain key talent. Some solutions for companies in this position include redesigning compensation programs to meet specific issues and effectively communicating the program to employees so they understand the reasons behind compensation changes that may be unpopular. The right solution depends on the specific financial condition of your business and industry. Strong and trusted leadership goes a long way to assure employees that their best interests are being balanced with the financial challenges confronting most businesses at this time. 

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