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EFFECTIVE VARIABLE PAY PROGRAMS
QUARTER 4, 2002

Overview

As organizations seek better ways to reward their employees and link rewards to performance, the prevalence of variable pay and incentive pay programs has grown, while base pay adjustments have slowed. Plan sponsors and participants alike have questions relative to introducing new programs, and those companies that have a long history of incentive compensation have nagging questions as to the effectiveness of their plans.

Introduction

Short-term variable compensation (typically quarterly to annual incentives) has become a critical component of most organizations' total reward programs. As plan use grows, managers now question whether incentive plans positively influence behaviors in such a way that they improve performance beyond a level achievable in the absence of such incentive plans.

Key Questions:

1. Would the same or better performance occur without the incentive plan?
2. Do participants rally behind the performance expectations established in the plan?
3. Do participants feel that they can have an impact on performance, or do they just appreciate the payout when it occurs?
4. Do the effort and contributions of the participants impact this performance period or future ones?

Difficult questions to answer. Some things we know.

Prevalence

Variable or incentive compensation has been steadily growing for the last 10 years in both participation and opportunity, while fixed base pay increases have declined slightly.

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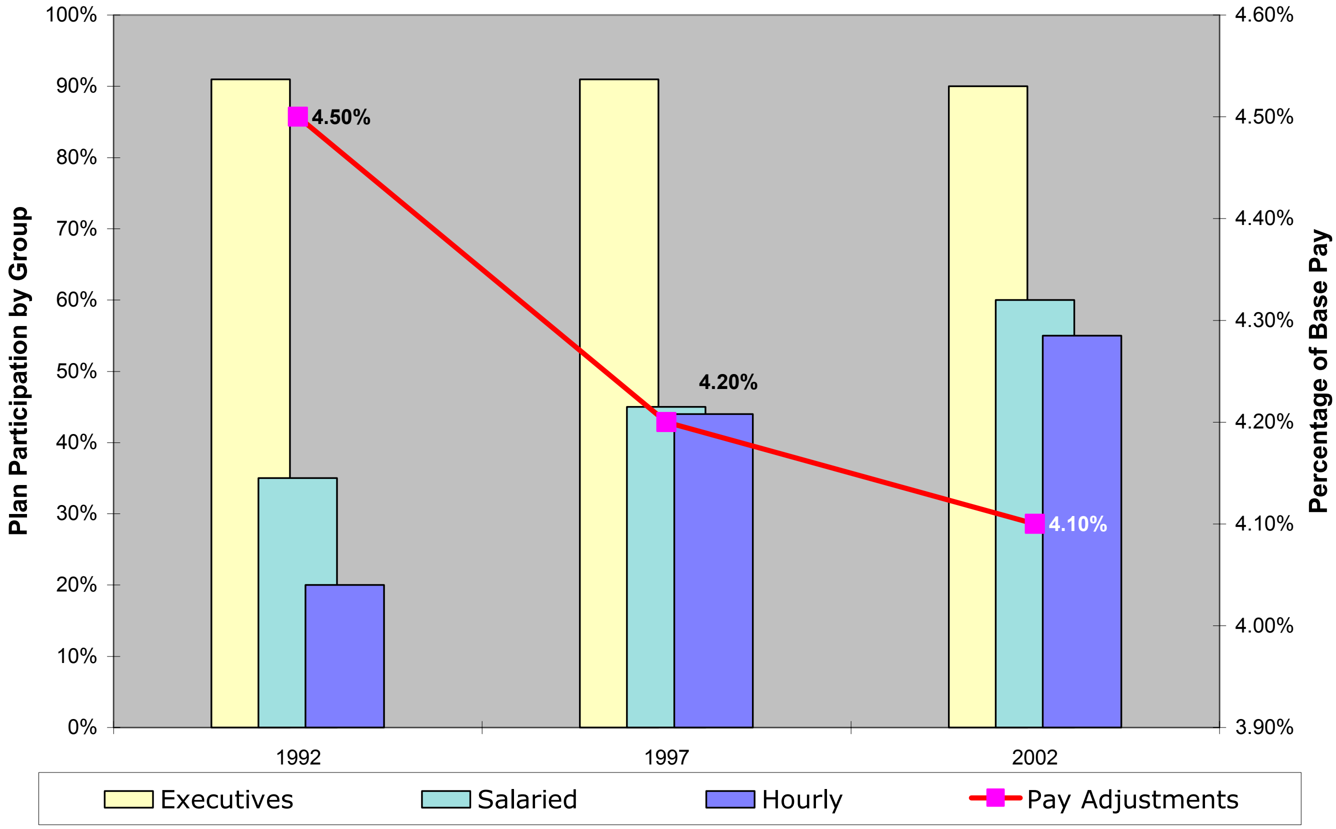
Incentive Plan Prevalence and Base Salary Adjustment Levels



Source: Buck Consultants, Mercer, WorldatWork, 3C analysis

Performance Measurement or Metrics

No shortage of performance metrics exists, but finding the appropriate balance between corporate, business unit and individual metrics is an ongoing challenge. Organizations are caught between the poor line-of-sight of profitability and strong line-of-sight of team and individual goals.

Common Corporate	Common Business Unit	Common Individual
Net Income/Earnings	Plan/Budget	Individual goals
Plan/Budget	Operational indicators including revenue, cost, units, output	Performance rating
Revenue growth		
Cash Flow/EBIT/EBITDA		
Customer/Stakeholder satisfaction		

Source: 3C summary of client metrics, 3C analysis of proxy statements

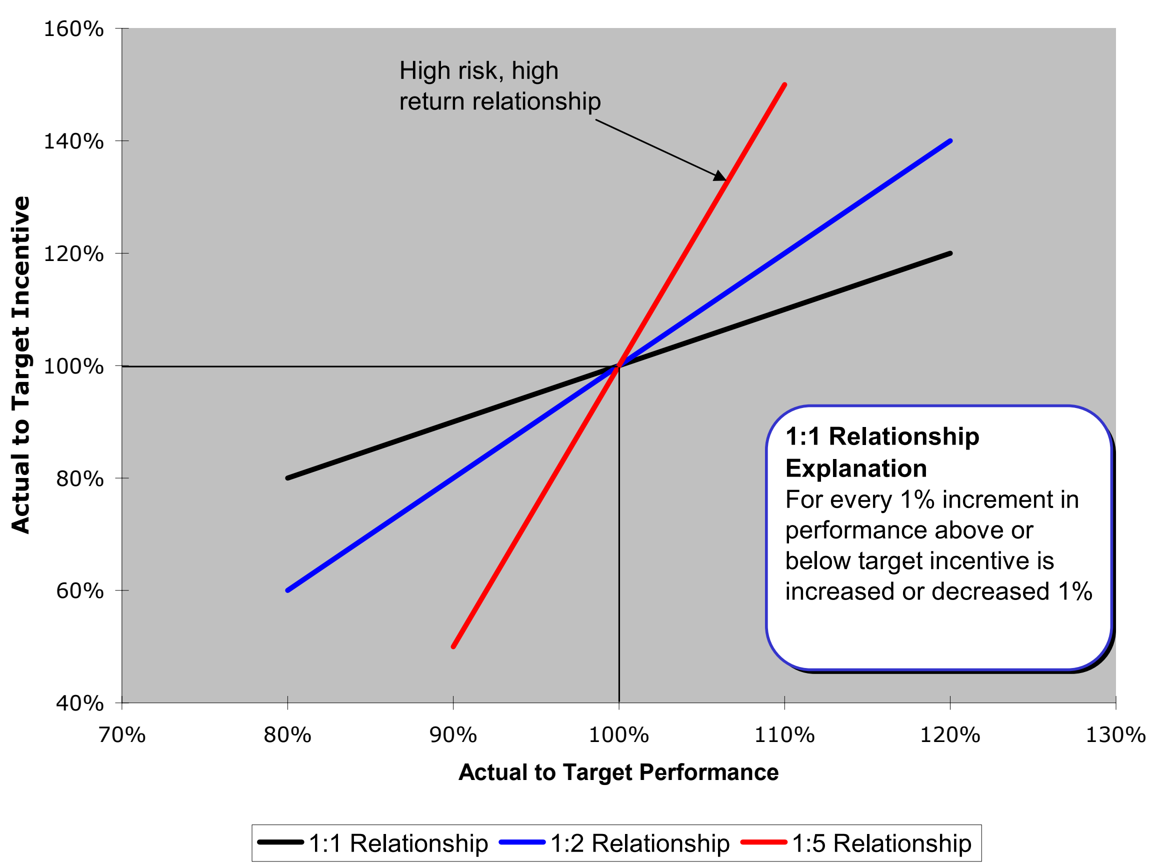
Key Plan Design Features

Most plans have common plan mechanics and features; performance metrics, incentive opportunity, leverage and timing, however, will vary from one plan to the next.

Leverage

Should actual performance at 110% of target yield an incentive that is 10% higher than the target incentive or should it yield two to five times that amount? Conversely, should performance that is 10% below target yield an incentive 10% lower than the target incentive or one that is two to five times lower?

Incentive to Performance Leverage

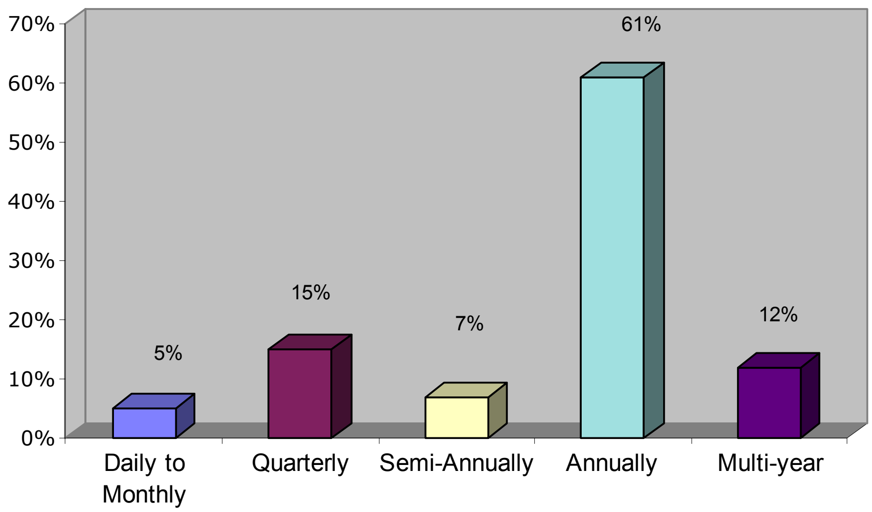


A critical consideration in determining appropriate leverage is the relative positioning of performance targets to industry norms. If the performance targets are industry leading, the plan could reflect higher than average opportunity, with modest downside leverage and high upside leverage. Conversely, if the performance targets are within industry norms, high leverage may be appropriate on both sides of target. One-to-one leverage works well when the participation base is high and ease of communication is paramount.

Timing

While most incentive plans have 12-month performance periods consistent with the company's fiscal year, the trend has been to move to shorter goal measurement periods and distribute the annual award over two or more payouts in order to encourage employee retention.

Incentive Payout Frequency



Source: 3C analysis

Intractable Design Issues

Two issues challenge most incentive plan sponsors: Target Setting and Line of Sight

Target Setting

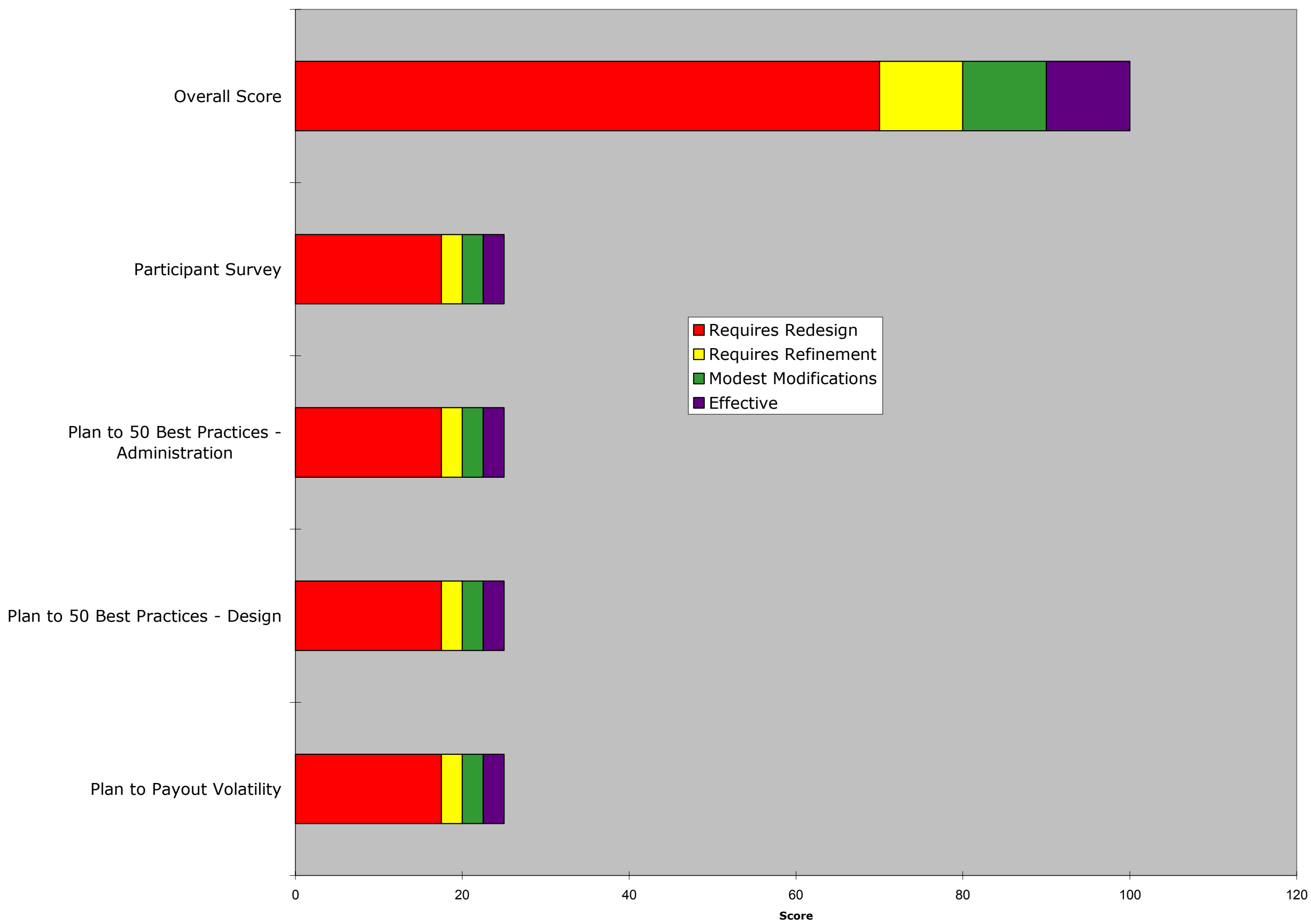
Set unreasonable targets or create a budget sure to win approval but impossible to achieve, and participants disengage. Set easy targets, and shareholders feel uncomfortable about the relative distribution of rewards and returns. Speak with most plan participants, and they have reasonable expectations when considering future performance relative to prior results. In general, participants think that better performance is attainable in the future and, if it is not realized, incentive levels will be lower or not paid. The key balancing act that plan sponsors have to consider is finding the sweet spot in the incentive curve where participants feel the expectations are attainable *and* the results justify the cost.

Line of Sight

Most would agree that measuring individual contribution is the easiest way to engage participants in an incentive plan and maximize their contributions. An organization, however, is a collection of many employees who produce a collective result that often cannot be easily tracked back to the individual level. Additionally, the ongoing viability of any incentive plan is its direct link to improved organization performance. Therefore, organizations must demonstrate the linkage between individual contribution and bottom-line results through extensive communication and training or go further and base the incentive award on organization performance, with individual performance factored into the incentive pool distribution. The challenge is focus too much on corporate performance, and the result is a profit-sharing plan. Focus too much on individual performance, and it is easy to lose sight of organization performance altogether. A comfortable middle ground is to make the link between individuals and the overall organization and ensure that rewards (when delivered) vary based on individual contribution.

Measuring Incentive Plan Effectiveness

Plan effectiveness can be measured on four scales: Plan design to best prevailing practices, plan administration to best prevailing practices, plan payout volatility to bottom-line financial volatility and participant satisfaction (via survey). These incentive plan measures provide insights as to whether the plan is well designed according to generally accepted plan design principles, and whether plan payouts are consistent with overall financial performance measured in earnings growth and/or cash flow growth. The participant survey also gauges employee perception ─ how participants rate an incentive plan's competitiveness and fairness, their views on whether or not they think they can influence performance results and their feedback on incentive plan communication and overall effectiveness. Plans not meeting threshold scores are subject to review.



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The key to this scoring mechanism is ensuring that the plan payouts are consistent with bottom-line outcomes, even if plan measurements are not based directly on bottom-line outcomes. To the extent that there is inconsistency between plan outcomes and company outcomes, the source of the issue(s) may be in plan design, including reasonable target setting; plan administration, including plan payout timing; or employee communication, including demonstrating how participants can influence the performance level leading to plan payouts.

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