

# Executive Compensation

## Bulletin

### New Research Tracks the Evolution of Annual Incentive Plans

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In the midst of economic turmoil and intense focus on all compensation programs, annual incentives continue to serve an important role in most organizations. Despite the widespread reductions in plan funding during the economic downturn, companies remain committed to annual incentives because these plans communicate and reinforce the most important organizational objectives, encourage desired behaviors and help provide competitive total compensation opportunities.

In many respects, the past few years have posed unprecedented challenges for companies in managing reward programs and costs. Companies in many cases have responded to economic pressures by making temporary and tactical changes in their programs, and economic uncertainty continues to cloud the picture. A sharp focus on cost management continues to dominate many companies' decisions with regard to annual incentives, although we see growing attention among our clients to the potential short- and long-term talent implications of today's cost-driven decisions.

To help companies ensure that their annual incentive plans provide competitive reward opportunities and remain effective in supporting key business and talent goals, Towers Watson conducts ongoing research in annual incentive plan design and operations. Our latest survey of annual incentive plan practices highlights the continuing evolution in plan design, along with some emerging trends in plan management. Conducted late in 2009, the new survey provides insights into how 212 large companies based in North America design the annual incentive plans in which their top executives participate. U.S. companies represent the bulk (83%) of the sample; Canadian companies make up 17%. The survey was first conducted in 1996, and again in 2001 and 2005. Following is an overview of some of the key findings of the most recent survey.

#### Plan Eligibility, Funding and Performance Measures

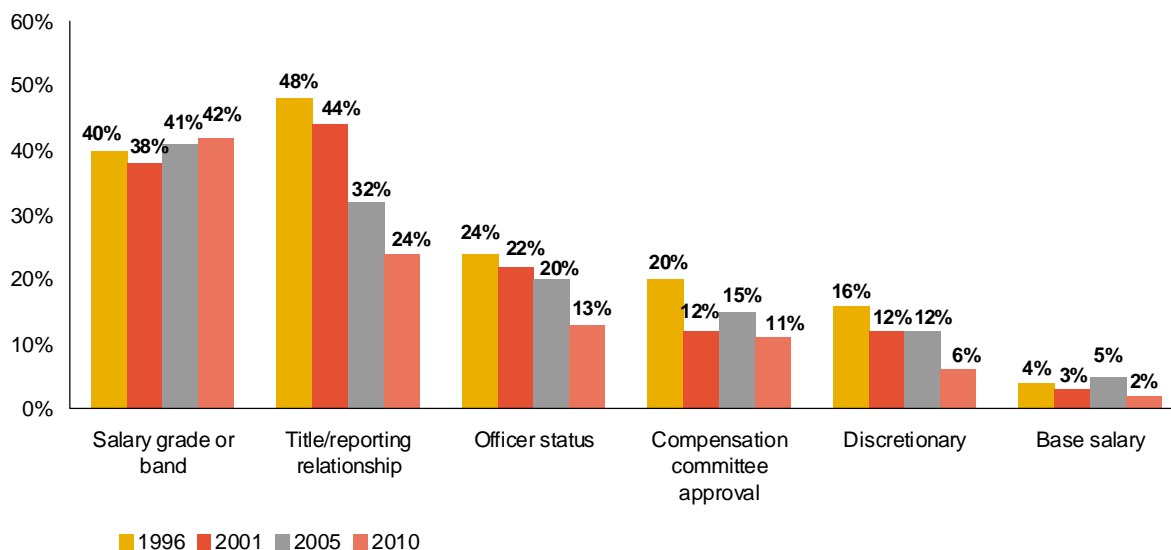
Among the noteworthy findings is the growing consistency in incentive plan designs within organizations over the past decade or so, which can be seen in the fact that more companies are altering eligibility requirements and offering a single annual incentive plan in which both executives

and other employees participate. In most companies today, the annual incentive plan in which the executives participate is also offered to employees below the executive level, while executive-only annual incentive plans are now a minority practice.

Eligibility to participate in an incentive plan is determined at each company according to one or more factors. In the 2010 survey, the most common factor for determining eligibility is an employee's salary grade or band (see *Exhibit 1*). This differs from prior years, when position title, reporting relationship or officer status was a more common factor used to determine incentive plan eligibility. This finding is consistent with the trend toward including employees at various levels in the organization in one plan. In the past, when most plans included in the survey were top-level executive plans, an employee's reporting relationship was a simple, straightforward identifier of role and contribution. With the plans now extending further into the organization, a more rigorous, contribution-based system (such as salary grades or bands) is being used to determine eligibility.

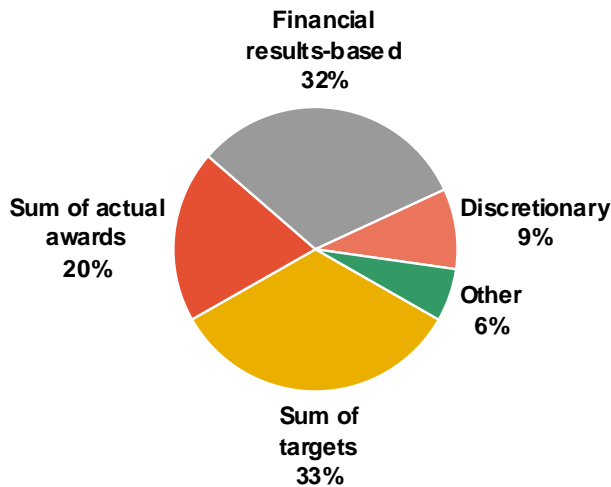
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**Exhibit 1** Historical comparison of the basis for determining plan eligibility



Another interesting finding relates to plan funding. Specifically, our latest survey shows continued growth in the use of funding formulas based on financial results to determine aggregate spending. As *Exhibit 2* shows, although the sum-of-targets approach to plan funding remains most prevalent, results-based funding is now a close second, reported by 32% of the survey respondents (up from only 13% in the 2001 survey). The most prevalent results-based funding measures are cash flow and operating income in our latest survey. Net income was the most common results-based funding measure in our 2005 survey.

**Exhibit 2** How incentive plan funding is determined



In the drive to improve measurement and make compensation practices more effective, organizations continue to adjust their annual incentive plans by altering design features, usually in ways that are important to the individual participants but don't involve a wholesale redesign. While cost is always a consideration for employers sponsoring these plans, the typical design changes are done with an eye on improving the line of sight between individual behavior and the organization's business objectives.

Consistent with our 2001 and 2005 surveys, nearly nine out of 10 companies responding to our recent survey (89%) rely on two or more performance measures. What's more, two-thirds of the survey respondents (66%) reported that they currently use three or more performance measures.

While sales or revenue is the single most common annual incentive financial performance measure, four of the next five most common measures are earnings- or profit-based, and cash flow is now tied for the second most prevalent performance measure (see *Exhibit 3*). Performance measures showing the largest increases in prevalence, compared to 2005, are cash flow and EBIT/EBITDA. The combination of sales or revenue with other common financial measures suggests that the drive for "profitable growth" is as strong as ever.

Our latest survey shows continued growth in the use of funding formulas based on financial results to determine aggregate spending.

### Exhibit 3 Prevalence of financial performance measures

	2010 Survey	2005 Survey
Sales/revenues	34%	31%
Earnings per share (EPS)	26%	29%
Cash flow	26%	19%
Operating income/operating profit	25%	28%
Earnings before interest and taxes (EBIT, or EBITDA)	25%	19%
Net income/earnings/profit	24%	24%
Cost/expense control/reduction	17%	-
Return on investment/return on invested capital (ROI/ROIC)	8%	7%
Return on equity (ROE)	7%	9%
Operating measures, e.g., operating margin	7%	12%
Pretax income	5%	7%
Working capital	4%	-
Economic profit/economic value added (EP/EVA)	4%	3%
Gross margin	4%	-
Return on assets/return on net assets (ROA/RONA)	3%	4%
Total shareholder return	3%	-
Net operating taxes after tax (NOPAT)	2%	-

### Other Findings

Here are some additional findings from our most recent survey:

- There has been continued use of broader and more complex ranges of performance measures, in an effort to improve measurement and line of sight.
- Incentive zones and associated payout ranges have remained largely unchanged over the past 10 years.
- The survey points to a continued decline in the use of voluntary deferred compensation arrangements, reflecting the additional restrictions imposed by 409A.
- Tying target bonus opportunities to “peer” or market is a near-universal practice in our latest survey. The trend away from this approach that we saw in the 2005 survey has reversed.
- Plan costs — the level of spending on annual incentive plans as a percentage of net income or revenues — are mostly aligned with the data collected in 2005. Actual spending for the most recently completed year was below target and historical levels. In addition, actual spending for the current/ongoing year was generally expected to be 20% to 30% below target. Plan cost comparisons are based on survey responses provided in the October/November 2009 time period.

Performance measures showing the largest increases in prevalence are cash flow and EBIT/EBITDA.

- The use of individual performance as a weighted measure has been stable for the CEO, reported by about one-third of the survey respondents, and has increased from a third to about half of the companies surveyed for positions below the CEO level.
- In addition to using individual performance, companies are showing increased use of measures at the group/sector and business unit/division levels. Companies appear willing to accept added complexity and differentiation within their plans in exchange for enhanced line of sight and stronger linkages to performance.

Finally, it's worth noting that there appears to be a shift in how companies set performance expectations, with a majority of companies currently basing goals on "expected business conditions." In the past, this method was used less frequently and was less common than goal setting based on budgeted performance and year-over-year growth or improvement. Whether this reflects a temporary reaction to a difficult economic environment or a more lasting trend remains to be seen, of course.

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