Managing your total rewards investment in an uncertain economy

Current financial and market conditions are creating heavy liquidity and capital challenges for many organizations throughout the country. These conditions have profoundly changed the business operating environment for most companies. The diminishing value of company assets erodes borrowing power to sustain business continuity. Commercial banks and lenders are focusing more on cash generation than income when making decisions about extending credit or investing. Highly leveraged companies may not be able to obtain credit, and moderately leveraged companies, as well as those companies in industries at risk, are already finding financing difficult.

As companies strive to increase working capital to finance continued operations, compensation investments and costs, among the largest line item expenses, can be permanently or temporarily reallocated toward a business investment or to service debt, fund operations or build cash reserves.

Decisions about reallocating and reducing compensation dollars can be driven by careful consideration of four factors:

1) FINANCIAL — The anticipated severity and length of the recession's financial impact on a particular company will likely be the primary consideration, and should dictate an organization's current and anticipated "performance status" which falls into one of four categories:

- Healthy
- Underperforming
- Turnaround
- Crisis

The size or severity of the reallocation of compensation dollars is supported by reasonable projections identifying "how much is needed" and for "how long" based on the anticipated performance status.

2) STRATEGIC — Companies must re-validate their current compensation philosophy or strategy in order to prioritize potential compensation program adjustments (e.g., emphasis on direct versus indirect compensation, criticality of specific benefit programs, bonus plans, etc.).

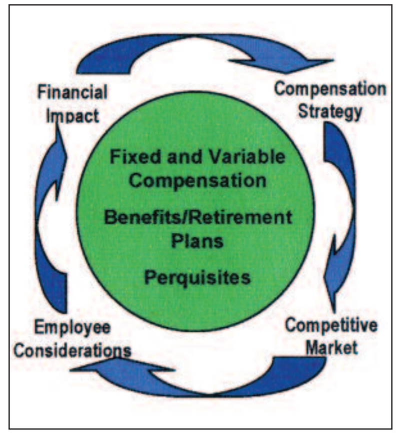
3) COMPETITIVE — Market competitiveness assessments of compensation and benefits programs should be reviewed (or conducted) to identify which components of total compensation are furthest above (or below) the market and can most (or least) withstand reallocation of compensation dollars.

4) EMPLOYEES — Specific employees (or categories of employees) may be key differentiators in a company's business model. The potential loss of mission-critical talent due to compensation reductions needs to be balanced against the savings. Loss of key staff may be unacceptable due to the following factors:

- Inability to execute key strategies
- Significant replacement costs
- Loss of intellectual capital
- Impact on customer relationships
- Poor morale among remaining workforce
- Creation of potential competitors

Companies considering reallocations of compensation investments should evaluate reallocation opportunities in the context of these four factors so that the resulting approach positions the company to respond most effectively to current and anticipated economic challenges (see illustration, top right column).

All components of a company's total compensation program should be evaluated as potential sources of reallocation:



- Base salary
- Short-term variable compensation
- Long-term variable compensation
- Health and welfare benefits
- Retirement benefits
- Perquisites

Companies will evaluate a wide variety of possible options (both temporary and permanent) within each component of their total rewards program in order to properly identify a specific approach or a number of approaches to reallocating capital. Each reallocation strategy carries implications for how severely employees will be impacted (and/or how they perceive being impacted), and for how long employees will be impacted (and/or how long they perceive being impacted).

Reallocations delivering considerable financial value and perceived as "severe" at some organizations may deliver low financial value and fall under employees' radar at other companies. While the following lists of program changes may not be considered exhaustive, many of the alternatives available to employers are provided.

BASE SALARY — Options include:

see **TOTAL REWARDS** *page 12*

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TOTAL REWARDS

Cont. from page 11

- Scale back planned increases
- Postpone increases
- Eliminate increases or "freeze" salaries
- Reduce work schedules
- Reduce salaries

Base salaries serve as the foundation of the basic employer/employee relationship; while reducing base pay costs across an entire workforce or by organizational level may yield considerable capital, employees' trust and their level of engagement may be threatened. Scaled back or postponed salary increases will yield fewer dollars in the long term; work schedule and salary reductions will yield more dollars in the short term.

SHORT-TERM VARIABLE COMPENSATION — Options include:

- Reduce fixed costs and enhance the value of plans by reallocating salary dollars to annual incentive opportunities
- Elevate/modify performance criteria to tighten the relationship between pay and performance, possibly reducing compensation costs and enhancing the return on the investment
- Move annual variable costs to future variable costs by reallocating annual incentive opportunities to long-term incentives and/or requiring employees to defer whole or partial planned annual incentive award payouts
- Eliminate compensation costs by requiring plan participants to forfeit their awards for a particular year or by permanently eliminating the incentive program

Companies should be cautious of changing annual incentive program design features or deferring/withholding earned awards due to contractual obligations and legal and tax (e.g., IRC 409A) obligations.

Existing plan metrics may no longer support the evolving business strategy (e.g., awards may still be driven by earnings while the company is now focused on working capital) and can, therefore, be modified. Preferred approaches still allow the earned dollars to be awarded, albeit under a different program and/or at a later date so plan participants understand that their elevated efforts will still be rewarded.

Moving fixed costs to variable and deferring awards will likely yield fewer dollars at a later date, and may still require accrual accounting for the awards during the deferral period. Incentive award forfeiture and/or program elimination may yield more dollars depending upon the number of plan participants, but the capital may not be available until a later date. That is, an incentive opportunity is not likely to be eliminated very late in the performance period but rather for a future performance period.

LONG-TERM VARIABLE COMPENSATION — Options include:

- Enhance the value of plans by moving annual incentives to long-term by reallocating short-term incentive dollars to long-term incentive opportunities
- Introduce/elevate performance-based grants and performance-based vesting schedules to tighten the relationship between performance and pay presumably reducing compensation costs and enhancing the return on the investment
- Move current costs to future costs by requiring employees to defer planned award distributions to future dates
- Eliminate compensation costs by requiring plan participants to forfeit their awards for a particular year or years or by permanently eliminating the incentive program

Prior to adopting any of these strategies, companies should carefully examine the implications of existing contractual agreements for the incentive plans or any currently enforceable employment and severance agreements, as well as all relevant tax regulations (e.g., IRC 409A) before:

- Requiring plan participants to defer full or partial awards
- Requiring plan participants to forfeit awards
- Eliminating plans

Long-term incentives are typically provided for senior executives; therefore, the adjustment of these plans may result in moderate savings. However, the adjustments will align with other employees facing pay reductions because "everyone is taking a hit."

Reallocating annual variable compensation to reward long-term results and deferring potential awards may only yield minimal dollars depending upon the variability of the plan, and this only at a later date. Budgeted awards will likely need to be carried as an accounting accrual during the deferral. Award forfeiture and plan elimination may yield more dollars but availability of compensation funds will depend upon the timing of anticipated awards.

HEALTH AND WELFARE BENEFITS — Options include:

- Review plan cost and coverage to identify inefficiencies
- Reduce employer contributions, modify eligibility, increase employee cost-sharing features, introduce consumer-driven health plans
- Significantly change benefit plan design (e.g., reduced level of coverage, eliminate low-value features or introduce health savings accounts)
- Eliminate plan or reduce benefits significantly

The employees' individual and family usage of company heath benefits will likely drive their perception of value and what they consider to be "affordable." Changes to program coverage and funding may yield very high dollars but the availability of dollars originally allocated to these plans will depend upon the timing of the company's contractual obligations.

RETIREMENT PROGRAMS — Options include:

- Review plan costs and reallocate coverage to key contributors
- Reduce employer matching formula and/or modify plan design
- Eliminate employer match and/or restructure retirement benefit arrangements
- Chart a path towards plan elimination

The employees' perception of the "value" of their retirement plan will determine the impact of plan modifications. Some employers have a considerable gap between their high level of investment and their employees' low perception of value; other employers provide a financial safety net that their employees value more than cash compensation.

Companies anticipating significant future capital needs should gradually migrate their plans towards those

see TOTAL REWARDS *page 14*

TOTAL REWARDS

Cont. from page 12

allowing added flexibility. Changes also must conform to relevant IRS and Department of Labor requirements. While changes to 401K, pension and profit sharing plans may yield very high dollars, the availability of capital originally dedicated to those plans may be delayed due to the timing of planned program funding.

PERQUISITES — Options include:

- Enhance executive and employee perqs as a recruitment and retention tool
- Review perqs program participation and associated costs to reduce eligibility
- Reduce the value (and cost) of employer-provided perqs
- Eliminate perquisites entirely

Perquisite programs in general should be positioned and priced at a level commensurate with their overall total rewards program (e.g., if base salaries are positioned at the 40th percentile of the market with no variable pay opportunities, perqs should probably be non-existent or at least very minimal). The amount of capital that may be reallocated by reducing and eliminating perquisites may be minimal, while maintaining these programs sometimes enables employers to easily recruit and retain specific types or critical talent.

PRACTICAL IMPLICATIONS — Companies trying to survive a recession must balance the need for working capital with that of funding a long-term human resources strategy. Just as a company's need for a capital infusion may be immediate and/or long-range, the modifications and reductions they make to their compensation programs will have short- and/or long-term impact on recruitment, motivation and retention. Companies anticipating prolonged recessionary conditions or a significant industry downturn may be required to rethink their compensation philosophy to reflect more permanent or significant changes to their overall program.

Much of the way changes to compensation and benefits are perceived by employees is driven by presentation and optics. All planned changes should be clearly communicated to all affected employees in a straightforward manner, including the company's financial challenge and planned solutions. Those organizations considering changes or a reduction to workforce compensation programs should consider the same or similar reduction to the corresponding executive program(s). While the actual dollars re-channeled from executive programs may not be as significant as that from the workforce, reductions to executive programs may promote a perception of fairness among employees.

Reallocation or reduction efforts across multiple components of total compensation are recommended when feasible. The following example illustrates adjustments to multiple components of compensation and benefit programs:

- six month 10 percent workforce salary reduction
- six month 20 percent executive salary reduction
- one year elimination of executive bonuses
- one year 50 percent cut in 401K match
- one year elimination in profit-sharing contribution
- Implement consumer-driven health care program at next open enrollment

There is a threshold in the reduction of compensation levels and opportunities at which undesirable attrition becomes a sure outcome. The capital reallocated will not likely match the capital needed to recruit and replace critical talent. Reallocations across multiple forms of compensation is recommended as it allows companies to make smaller, possibly uniform reductions to a variety of programs, thereby preserving the integrity of the existing total compensation strategy, and hopefully the cultural and motivational status quo.

***** For purposes of this article, total compensation is defined as base salaries or wages, employee benefits, annual and long-term incentives and perquisites.***

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