

# Compensation Guidelines in a Recessionary Environment



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In today's economic environment, reductions in staff (layoffs) are a primary step in satisfying operating budget constraints in many companies. This article addresses the current economic realities and provides alternative compensation guidelines to minimize these reductions, capture market share and exceed companies' profit goals by facilitating retention. It also covers the selective recruiting of desirable talent to achieve these objectives and lay the groundwork for business growth and continued success when the economy recovers. The compensation guidelines provided in this article address the following compensation components: base salary; short-term or annual incentives; and long-term incentives.

This paper is the collaborative result of six highly seasoned compensation professionals who together represent more than 200 years of experience in all phases of compensation including: base salary; short-term incentives; sales compensation; long term-incentives; and board compensation.

Some companies may be actually growing, while others may be fighting for survival. Companies may have multiple business units that are differently impacted by the economic recession. It is incumbent upon the CEO, CFO, COO and chief human resource officer to recognize the relative economic impacts and accordingly set budgets and objectives.

This article provides a set of compensation guidelines to address the decision-making that will facilitate a company in meeting its business objectives relative to five levels of economic circumstances businesses might be facing — from little or no impact from the economy to severe impact. The national security code colors are being

**FIGURE 1 Levels of Economic Impact**

| Economic State   | Definition  |
|--|---|
| <b>Low</b><br>(Economy Having Little Effect)                   | The company or a division is not being negatively impacted by the current economic circumstances. Management feels comfortable in meeting business objectives and good or above targeted results are expected.  |
| <b>Guarded</b><br>(Some Signs of Distress But Not Significant) | The company is not being negatively impacted by the current economic circumstances, but is starting to see results trend downward. Management feels optimistic in meeting business objectives and good results are expected, but is cautious about its expectations.                  |
| <b>Elevated</b><br>(Worried and Things Are Getting Difficult)  | The company's ability to achieve prior results is starting to get more difficult. Management knows it is in a different ball game and goal achievement is more of a stretch. Costs are being closely looked at and forecasted results will be significantly less than the prior year. |
| <b>High</b><br>(Performance Heading Downhill)                  | The company is financially vulnerable. Performance will be much lower than what management has been used to achieving. In fact, the expected results are poor.  |
| <b>Severe</b><br>(Performance in the Tank)                     | The company is in a survival mode. Expected results are terrible and there is practically no chance of meeting current forecasted budgets and goals.  |

utilized along with descriptive words to provide a means of addressing multiple levels of negative economic impact on companies. Multiple short definitions have been developed to consider each economic level a business might be facing. (See Figure 1.)

It is important to note that there will be no universal quantitative metrics to support these definitions. Each business is unique and the quantitative factors will vary by industry and competitive strength within each company's industry.

The negative economic impact varies from business to business, and region to region. It reduces the ability of people to freely change jobs. Employees are more willing to accept job security over increases in compensation. The economic realities require compensation restructuring and adjustments. Those are the knowns.

## COMPONENTS OF PAY

The following sections provide guidance on the various components of pay from executives to sales employees.

### Base Salary

We have learned some key lessons from past recessions. In past recessions, companies moved quickly to downsizing to reduce cost but then found themselves in a difficult situation when the economy recovered. Companies lost some of their significant assets — their human capital. This time around, other options need to be considered to avoid reductions in force and retain the key differentiator for a company's future success — its talent. That's because as quickly as companies

found themselves in this recession, they could find themselves on the road to improvement because the global economy and the lightning speed of electronic communications may make recovery happen much more quickly than in past recessions. We need to be ready for that.

Before recommending a course of action, it's important to take into account the landscape and environment for a company given the various criteria shown in Tables 1 and 2:

**TABLE 1 Considering the Business Landscape**

| Factors Impacting Decisions   | Definition  |
|-------------------------------|---|
| Company culture               | Family vs. "eat to kill"; paternalistic vs. futuristic; high trust vs. secretive; traditional vs. liberal; conservative vs. fast-paced.                   |
| Compensation philosophy       | Treat everyone the same vs. significant rewards to some and small or no rewards to others.  |
| Internal organization factors | Internal equity; seniority-based; decentralized or centralized; unionized vs. non-unionized; highly professional based organization vs. more blue collar. |
| External organization factors | Global or local; service orientation; type of industry.   |
| Workforce demographics        | Type of worker, age, sex and ethnicity.   |
| Non-discriminatory            | Actions need to be legally defensible.  |

**TABLE 2 Responding to the Economic Crisis**

| Variables              | Description  |
|------------------------|--|
| Organization structure | Flat or several layers of management.  |
| Compensation structure | Is there one in place? Does it have broad bands or is it based on every job having its own point rating?                           |
| Hierarchy of jobs      | Are there several hierarchies with various skills and experience levels or more individual contributor jobs?                       |
| Job requirements/size  | Are job requirements overlapping? Is there a team-based approach in place?   |
| Timing of increases    | Common review date or anniversary-based review dates. Increase amounts are more COLA-like vs. larger increases for top performers. |
| Processes              | Lots of manual interaction or more systematized.   |
| Communications         | Open and transparent vs. closed and secretive.   |

When considering how to respond to the economic crisis with respect to base salary, several variables come into play as detailed next.

As we look at the impact of base salary on companies at various points of the economic continuum, in this section we consider a range of possible responses to ride out these turbulent times.

In every economic situation, approaches are provided that touch upon the following elements:

- Organization structure
- Compensation structure
- Hierarchy of jobs and job requirements and their size
- Timing of increases and increase amounts
- Processes
- Communication.

This section of the article presents approaches for reducing base salary costs without having to reduce staff. Options are provided for a range of companies from those characterized as “Low,” to those that are in “Severe” financial straits.

For those companies that are in a “Low” category, such as an Exxon, Abbott or McDonald’s, the approach would be to not change anything in their current organization, compensation or position structures.

It would, however, be recommended that the major portion of their salary increases be focused on top performers and top skill talent.

In terms of processes, companies in this category need to ensure the right levels of approvals are in place for salary increase levels and that they monitor those increase dollars for out-of-guideline increases and “peanut butter” approaches for allocation of increases.

Even though the company is in good financial shape, it still would be appropriate to communicate where the company stands now and that, if its financial situation worsens, additional actions may need to be taken.

If a company is in a “Guarded” state from a financial perspective, it should be proactive in its approach.

The company should begin to review its organization structure to remove unnecessary layers.

In terms of its compensation structure, the company should consider collapsing its various jobs that may be placed into many grade levels into a job family or career ladder type of structure so it becomes less internally focused and more customer and market focused.

The company should strongly consider ways to reduce its salary increase spending. It could: lower the merit increase budget; delay the timing of increases; reduce the workweek for a period of time; require employees to take one to two weeks of unpaid time off; or a combination of these.

The administrative compensation, payroll and systems processes need to be adjusted to reflect whatever approaches the company has opted to take. Management should eliminate any process steps that can streamline the operation. It’s also important to ensure appropriate approvals are in place and that the impact of any changes is monitored.

Communication should be clear and transparent as to why the company is pursuing these actions now and also to highlight the fact that additional actions

may need to be taken should the company’s financial situation deteriorate.

For companies in the “Elevated” category, the approaches we discussed for the “Guarded” company now need to be acted upon versus just reviewed.

Unnecessary layers in the organization need to be eliminated.

The compensation structure should be collapsed into fewer job levels/grades with broader salary bands/ranges.

The “Guarded” company needs to put into play actions, such as salary increase deferments, that were discussed. The degree to which these are implemented will depend on the amount of cost reduction that needs to be achieved.

The change in processes and communications should be at a heightened level.

For those companies in a “High” category, the lowest common denominator ought to be pursued in organization, compensation and job structure. This gets translated into removing any unnecessary layers and combining roles in the organization.

Jobs should be grouped into career ladders with broader and fewer pay bands.

Base salaries could be frozen at current pay levels and any salaries over pay band or salary range maximums could be reduced to the maximum of the band or salary range.

Processes and policies need to be revised across the board to reflect the new realities.

Communication needs to be clear and transparent regarding the rationale for these actions.

For those companies in the “Severe” category, actions that are suggested for the “High” category companies need to be taken in these situations. However, the

FIGURE 2 Recommended Courses of Action

| Economic State   | Organization                    | Compensation                                  |
|--|---------------------------------|---|
| <b>Low</b><br>(Economy Having Little Effect)                   | No change                       | No change                                     |
| <b>Guarded</b><br>(Some Signs of Distress But Not Significant) | Start delayering review         | Collapse job levels and broaden salary ranges |
| <b>Elevated</b><br>(Worried and Things Are Getting Difficult)  | Reduce layers and combine roles | Same as Guarded                               |
| <b>High</b><br>(Performance Heading Downhill)                  | Same as Elevated                | Same as Elevated                              |
| <b>Severe</b><br>(Performance in the Tank)                     | Same as Elevated                | Same as Elevated                              |

changes will need to be made immediately and the degree of the changes will be greater than any of the other company situations we've discussed in order to achieve the greater cost reductions that are necessitated by the company's financial condition.

Base salaries would need to be reduced across the board. The extent of the reduction can be higher at the senior management level and lower moving down the organization. The same action mentioned in the "High" category with respect to reducing salaries over the pay band maximum to the maximum of the salary range or band should be considered.

Figure 2 summarizes the recommendations that should be considered by companies in various economic stages.

### Short-term or Annual Incentive Compensation

For the short-term or annual incentive compensation element of total compensation, companies need to focus on three areas: the performance of the business; the performance of employees; and the cost impact of an incentive program to deliver the right performance from an ROI perspective.

#### The Business Performance Challenge to Improve:

- Overall business performance
- Performance in business units or functional areas
- Performance for targeted items such as operating costs, cash flow, quality and productivity

| Hierarchy of Jobs                             | Increases  | Processes                     | Communication   |
|---|--|-------------------------------|---|
| No change                                     | Focus on top performers  | Ensure accountability         | Alert employees as to current situation and possibility of a change |
| Group jobs into job families or career levels | Reduce   | Change to match new realities | Potential for change  |
| Same as Guarded                               | Defer. Limit pay to 110 percent of mid-point.  | Change to match new realities | Communicate rationale   |
| Same as Elevated                              | Consider pay freeze and reducing salaries over salary range maximum to maximum.                                    | Same as Elevated              | Communicate rationale   |
| Same as Elevated                              | Reduce salaries across the board. Consider reducing any salaries over pay band or salary range maximum to maximum. | Same as Elevated              | Same as Elevated  |

- Individual performance — need people to take on accountabilities and provide differential performance.

The People Performance Challenges are to:

- Improve the degree of employee engagement tied to the mission and purpose of the business.
- Reinforce pay for performance — the incentive plans need to connect employees' behaviors to performance that will improve business results.

The Cost Challenge is to:

- Rebalance compensation expense — pay needs to be appropriate and effective given the position and business expectations and results.
- Reduce total compensation expense effectively — maintaining ROI on compensation dollars.
- Preserve and enhance the company's cash position — this may never have been as important as it is now.

The set of variable elements below are utilized as a framework to discuss short-term incentives:

- Eligibility rules — the usual meaning — who or what jobs are covered by an incentive plan
- Size/range of award — the potential size of awards and the ranges of performance and metrics to which they are linked
- Performance metrics — the specific performance metrics themselves
- Performance period — changes to payout periods from the usual annual payout
- Form of payment — the forms of payment for the incentive
- Right to award — ultimate rights to an award or any contingent conditions beyond the normal rights of attaining the goal for the period and then receiving payment for the period
- Communications/administration — the company's communication to participants and the adaptability of its administration systems for any changes that need to be made

As described in the “Base Salary” section, this section presents the variable elements and corresponding approaches for short-term incentives according to business conditions. The general approaches to the variables are:

- Purpose — retention and reinforcement of results
- Eligibility — change eligibility requirements
- Size and range of awards — remix or reduce
- Performance metrics — quantitative and discretionary
- Payout period — annual or deferred to multi-years (also mid-year) making changes with your 409A expert at your side
- Form of payment — cash, equity in the form of stock options, restricted stock or units; noncash such as time off or points programs

- Ultimate rights to awards/contingencies — vesting for deferred payouts and claw-back rules
- Communicate potential for changes, the why of changes — ensure ability to administer changes.

This section emphasizes only the points that change from one condition to the next — “Low” through “Severe.”

Companies that are in a “Low” impact position should re-evaluate all the performance metrics in the annual incentive plan to make sure that they are aligned with the company’s current market conditions and its revised strategy and operational plans.

The company should begin to consider amending the short-term incentive plan for clawbacks that would be based on any incorrect financial statements or information. It may also be appropriate to think about making payouts contingent upon future conditions.

The company should communicate the potential for change if the company’s conditions worsen. This is advisable even in the best of times.

Companies that are in a “Guarded” state should review the eligibility conditions for people to determine if the criteria are appropriate.

Time should also be taken to review the levels of award targets, thresholds and any maximums or caps. Also, performance ranges should be examined for validity against any revised financial expectations.

The company should consider adjusting some performance metrics downward. Operating metrics should be looked at as replacement for more general financial metrics.

Claw-back provisions should be added to the plan.

Companies that are in an “Elevated” financial state should consider granting retention incentives to keep key talent in place. In the place of formula incentives, discretionary bonuses should be allowed for select executives to recognize their individual contributions.

Positions that have low impact on results should be removed from this plan.

If management lowers performance standards in incentive plans to match anticipated conditions, it should look at concomitant reductions in targeted payouts and narrower performance ranges.

Performance metrics should be 100 percent quantitative operating metrics. Eliminate components based on individual performance objectives. Use hard operational measures such as cash flow, working capital and Earnings Before Interest, Taxes, Depreciation and Amortization (EBITDA).

The company should consider lengthening payout to multiyear periods, such as two or three years for one year’s results. It’s important that the company’s 409A counsel be consulted to ensure the plan design doesn’t run afoul of IRS regulations for deferred compensation.

A portion of the payout of the short-term incentives should be in the form of



equity to preserve cash. Add vesting requirements for equity portions as well as clawbacks on all forms of payouts (except noncash).

In an attempt to get ahead of the curve, provide purposeful communications about why changes are being made.

Companies in a “High” financial state should carve out all positions below senior management. For those carved out, create a discretionary bonus pool to handle any potential for incentive payments to these people for extraordinary results or effects they may produce.

A threshold of meeting the financial plan should be the basis for the threshold in the plan’s performance range. Any payout should be in the form of equity. Above that point, have a steep upward payout line or curve.

**FIGURE 3 Short-term Annual Compensation**

| Economic State   | Purpose   | Eligibility   | Size & Range of Awards  |
|--|---|---|---|
| <b>Low</b><br>(Economy Having Little Effect)                   | No change   | No change   | No change   |
| <b>Guarded</b><br>(Some Signs of Distress But Not Significant) | No change   | Review eligibility criteria for appropriateness   | Review award targets and performance ranges for validity                                    |
| <b>Elevated</b><br>(Worried and Things Are Getting Difficult)  | Grant retention incentives for key positions and discretionary incentives to select executives for individual contributions | Carve out positions with less effect on operating results                                   | Exchange reduced targeted payouts and performance ranges for lowering performance standards |
| <b>High</b><br>(Performance Heading Downhill)                  | Grant retention incentives for key positions and discretionary bonuses to select executives for individual contributions    | Carve out all positions below senior management; create discretionary pool for levels below | No payout unless targeted financial plan is achieved and then steep slope above             |
| <b>Severe</b><br>(Performance in the Tank)                     | Grant retention incentives for key positions and discretionary bonuses to select executives for individual contributions    | Carve out all positions below senior management; create discretionary pool for levels below | All discretionary   |

For companies in the “Severe” financial category, all payouts should become discretionary. Typically in a severe business environment, setting performance metrics becomes very difficult. The company needs to be able to balance creating alignment with shareholders and keeping executives engaged and retained to get the company back to successful performance levels. In this situation, there needs to be a set of compensation guidelines between the board and management as to the level of incentive payouts given the economic environment in which the company is operating — a formulaic approach just won’t work. It may be advisable to set some ranges of discretion for payout with some criteria tied to it. So if management achieves a certain level, the compensation committee has

| Performance Metrics  | Payout Period                | Form of Payment            | Rights to Award   | Communication & Administration   |
|--|------------------------------|----------------------------|---|--|
| Align performance metrics with current market conditions and strategy  | No change                    | No change                  | Consider clawbacks for incorrect financials or future performance     | Communicate potential for change if company’s financials worsen            |
| Adjust performance metrics downward; add operating or business results metrics                                   | No change                    | No change                  | Add clawback provision for incorrect financials or future performance | Communicate potential for change if company’s financials worsen            |
| 100 percent operating metrics, no individual component; use measures like cash flow, working capital, and EBITDA | Use multiyear payout periods | Payout a portion in equity | Add vesting for equity and clawbacks on all forms                     | Communicate why changes are being made. Be sure you can administer changes |
| 100 percent operating metrics, no individual component; use measures like cash flow, working capital, and EBITDA | Use multiyear payout periods | Payout all in equity       | Add vesting for equity and clawbacks on all forms                     | Communicate why changes are being made. Be sure you can administer changes |
| Discretionary based on meeting certain objectives that have been agreed upon with the board                      | Use multiyear payout periods | Payout all in equity       | Add vesting for equity and clawbacks on all forms                     | Communicate why changes are being made. Be sure you can administer changes |

the latitude to pay between 0 percent and 5 percent of target incentives. This should be reviewed quarterly.

Figure 3, on pages 14-15, summarizes actions to be taken by companies in various economic stages.

### Long-term Incentive Compensation

A well-developed long-term incentive plan (LTI) supports and reflects a company's long-term business plans. If the LTI creates the right balance between business and personal goals, there is no cost to the company. Unlike some of the plans we've read about recently, if a company's LTI plans are written well, a third-party reader should be able to understand a company's long-term business plans after reading its LTI plans.

Many of the problem executive compensation plans reported in the press seem to have been written for the purpose of creating personal wealth with little thought given about the company's long-term success.

A good LTI plan should be communicated well to both participants and shareholders. An important piece of that communication is to let the participants know that plan goals and payout periods may change based on the changing circumstances facing the company.

Executives and outside directors should have meaningful equity positions in company stock that is purchased with their own money. Perhaps our current financial crisis could have been avoided had companies implemented more stringent ownership guidelines.

If the current economic recession is having little impact on the company, or the company is in a "Low" category, the company should ensure that the LTI plan:

- Demonstrates its tie to the company's long-term goals
- Ensures that long-term goals have the flexibility to change based upon relevant market conditions
- Ensures that all plan participants are aware of the conditions under which plan goals might change.

If the company is in a "Guarded" economic state, the following actions should be considered:

- Makes plan participants aware that long-term goals are subject to change
- Possible changes that may be considered:
- Example 1: Goals are adjusted to take into account new market conditions
  - Example 2: Longer payout periods may be necessary if market conditions continue to deteriorate

If the company is in an "Elevated" state, the actions to be considered are to:

- Communicates the possible imminent change to the LTI plan
- Demonstrates possible changes to the LTI plan to ensure that the plan is balanced and cost effective
- Encourages key executives and directors to acquire and hold meaningful,

long-term equity positions in the company

- Begins implementation of enhanced long-term cash (e.g. performance units) and long-term performance shares based on achievement of significant performance goals.

If the company's financial situation is "High", the company should:

- Communicate that changes to the LTI plan are going into effect according to previously communicated guidelines.
- Make changes that will:
  - Recalibrate LTI to be balanced and cost effective
  - Redesign goals and payout opportunities to support long-term strategic goals
  - Ensure that all payouts are cost neutral.

If the company is in "Severe" financial straits, the company should:

- Communicate and reduce or eliminate emphasis on annual incentives
- Put increased weight on long-term incentives
- Ensure the LTI plan is balanced and cost effective
- Ensure LTI goals are structured to meet the company's unique needs
- Ensure claw-back provisions are incorporated to prevent participants from benefiting from possible wrongdoing.

Note: Under severe economic circumstances, the method for valuing long-term awards may have to change. Black-Scholes is not always appropriate.

## CONCLUSION

All sports teams have a playbook. The playbook provides an overall framework and strategy to use given any type of game condition. Companies need to employ that same approach. It's important to determine your company's status with respect to the overall model created. (See Figure 4). The questions you need to address are:

- What are the chances of a negative economic impact on your company?
- What is your company's business forecast?

FIGURE 4 Determining a Company's Economic-Level Status

| Low  | Guarded   | Elevated  | High  | Severe  |
|--|---|---|---|---|
| Causing little or no problems                        | Some signs, not significant                         | Worried, things are getting difficult   | Performance headed downhill                                   | Performance in the tank   |
| Excellent ability to meet short- and long-term plans | Superior ability to meet short- and long-term plans | Questionable ability to meet short- and long-term plans; financially vulnerable | A marginal ability to meet plans; very financially vulnerable | Almost no ability to meet plans; extremely financially vulnerable |
| Results great  | Results trending down                               | Results will be significantly below last year                                   | Results very bad  | Results terrible  |
| Enthusiastic   | Optimistic  | Pessimistic   | Worried   | Scared to death   |

## RESOURCES PLUS

For more information related to this paper:

[www.worldatwork.org](http://www.worldatwork.org)

Type in any or all of the following keywords or phrases on the search line:

- Base salary
- Short-term incentive
- Long-term incentive

[www.worldatwork.org/bookstore](http://www.worldatwork.org/bookstore)

- *Elements of Base Pay Administration*
- *Incentive Pay: Creating a Competitive Advantage*
- *Determining Compensation Costs: How-to Series for the HR Professional*

[www.worldatwork.org/education](http://www.worldatwork.org/education)

- Compensation Fundamentals Seminar
- Base Pay Administration and Pay for Performance Certification Course: C4
- Performance Management — Strategy, Design and Implementation Certification Course: C11.

■ How accurate do you think the forecasts are?

■ Can you afford not to be fully prepared in all compensation matters?

■ Are you fully ready to take proactive actions rather than reactive actions?

■ Do your compensation strategies prepare a war chest for necessary actions or inactions?

Companies need to develop a compensation playbook that can address all of the scenarios presented in this article. It's important that the organization has a roadmap to utilize when faced with various economic realities to help guide decision-making so it is done thoughtfully versus creating a "fire drill" mentality. In defining the roadmap, a company

FIGURE 5 Roadmap To Address Economic Scenarios

| Economic Status  | Program Changes Required | Base Salary Administrative/Process Changes Required | Communications Required |
|--|--------------------------|---|-------------------------|
| <b>Low</b><br>(Economy Having Little Effect)                   |                          |   |                         |
| <b>Guarded</b><br>(Some Signs of Distress But Not Significant) |                          |   |                         |
| <b>Elevated</b><br>(Worried and Things Are Getting Difficult)  |                          |   |                         |
| <b>High</b><br>(Performance Heading Downhill)                  |                          |   |                         |
| <b>Severe</b><br>(Performance in the Tank)                     |                          |   |                         |

needs to consider its culture, its compensation philosophy, internal and external organization factors and its workforce demographics. If a complete roadmap or playbook is developed addressing all of the various scenarios from “Low” to “Severe,” it should also outline the tools needed to successfully meet current business challenges. Figure 5 provides a template that could be fully developed for each type of compensation program a company has, addressing each type of economic situation. The data that are needed for decision making for each scenario can be spelled out as well.

Since many companies have divisions in various stages of maturity and financial condition, the roadmap or playbook can be an effective means of leading management through a process of change needed to achieve its business challenges successfully. If you wait for someone else or the economy to signal the change, it's often times too late. In today's global economy, the pace is fast, and having a playbook places your company in a better position to proactively address the impact that various business scenarios can have on compensation programs. ■

#### WEB EXTRA

To read ["Reconfiguring Sales Compensation to Meet Economic Conditions"](#) and ["Aligning Board Compensation During Difficult Times,"](#) login to the [WorldatWork Web site](#).

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