

Compensation Innovations in an Economic Downturn

February 2009

In late 2008, economists were still debating whether the United States was entering a recession or already in one, but many companies and entire industry sectors were already experiencing a recessionary business environment. Significant reductions in business volume, write-offs of previously recorded revenue, staggering losses of shareholder value, and layoffs were occurring regardless of academic opinion. Historically recessions are announced many months after they begin and sometimes after they have ended, and this one is no exception: In December 2008 we received official word that the current recession began in December 2007.¹ By this time, however, many employers were already implementing recession-driven employment-related actions — in some cases repeating mistakes of the past and in others developing

innovative approaches to the changed business environment.

Clearly this recession will be worse than any since the Great Depression. There are many dynamics indicating it will be different, too, from even the most recent recession as a result of greater globalization of the U.S. economy, booming economies in some countries, the weak U.S. dollar, volatile oil prices, and significant changes in employee pay practices and associated rules and regulations. During the last recession, we never discussed RSUs², HSAs³, FAS 123R expense⁴, 409A compliance⁵, the implications of the PPA⁶, and the executive compensation restrictions of EESA.⁷ And rarely did we hear the term ROI⁸ in an employee pay discussion.

Employers considering how to position their business in the economic downturn should revisit what has and has not been effective in the past and consider that solutions that worked in the last economic recession may not fare as well in this unprecedented environment. More importantly, a rigorous and longer-term ROI-based approach to decision-making may reveal some unexpected alternatives.

PAST PRACTICES

In the last recession — beginning in March 2001 and ending in November 2001, according to the National Bureau of Economic

Research⁹ — some sectors, notably technology and the related “dot.com” world — were hit harder than others. Despite this officially-designated timeframe, many employers continued to struggle through 2002 and well into 2003. Their tactics included the typical actions of layoffs, salary freezes, elimination of bonuses, and mandatory time off without pay. Others went still further with salary cuts, benefit program reductions, and forced use of paid time off during seasonally slow periods. We have seen all this, and more, in the current recession. All these actions focus on reducing expense, but while short-term reported profitability might have benefited, companies often incurred other significant costs that are more difficult to measure and identify. In fact, some companies might have cost themselves more than they saved.

For example, companies rarely measure and understand the total costs associated with layoffs and subsequent rehiring, tending to focus only on the hard-dollar savings of salary and benefit cost reductions, offset by severance costs. But the costs associated with the loss of accumulated institutional knowledge, reputational damage, and productivity deficits resulting from outgoing and, later, incoming employees may dwarf those savings. Research on “survivor syndrome” — the after-effects of a layoff on remaining employees — confirms behaviors including lower productivity and reduced risk-

taking.¹⁰ Other research supports the notion that a layoff frequently results in the best-performing and most valuable employees searching for new opportunities as they anticipate a layoff that would not include them.¹¹

When the economy bounced back from the last recession, employers found themselves back in the “war for talent” and using search and referral fees, hiring bonuses, large new-hire equity grants, and other tactics to get talent in the door. Changes in cash compensation, equity, benefits programs, and time-off policies were implemented in the heat of the talent battle, and the prosperous times masked inefficiencies and questionable financial returns.

Over the past decade, there has been continued progress in understanding the value of employees rather than merely the cost of those employees, but little has been done to incorporate these ideas into decision-making processes. While “human resources” has evolved into “human capital” and the term ROI appears in most HR-related literature, financial reporting rules in the United States and abroad do not accommodate the measurement and reporting of employee value as they do employee expense.

Financial reporting need not be a constraint on financial analysis, however, and developing financial models that estimate both direct and indirect costs of alternative actions is essential for assessing innovative alternatives for coping with changes in the business environment, both the current bust and the inevitable subsequent boom inherent in the economic cycle.

WHAT TO DO

Although rarely articulated as such, the job of the compensation manager — and the HR function overall — is to

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deploy the company’s capital to employees in a way that maximizes the long-term value creation of the company. Responses to economic recession often are targeted at reducing short-term expense and can be contrary to that objective. Employers can use the opportunity of an economic recession to innovate employee pay around five themes to achieve short-term cost savings without mortgaging future returns.

1. **Differentiate.** Given the limited differentiation of pay to employees in most companies, across-the-board actions such as a salary freeze result in further underpaying the most valuable employees and relative overpayment of the least valuable. Rethink the allocation of elements of the four general pay categories — cash, benefits, equity, and “time and place” — to identify cost-effective tactics that ensure the retention of high performers and more aggressive reallocation away from mediocre and poor performers. Research indicates that aggressively increasing the pay of the most productive employees can create a financial return of more than 200 percent¹² and yet most pay systems (other than some sales incentive programs) do not allow for significant variation.

Locking in top performers with significant retention awards funded by allocation away from those at the bottom of the “performance and potential” distribution can jump-start differentiation that can be continued in prosperous times. Possibilities include large grants of RSUs with cliff vesting to key contributors to retain them during the tumultuous period; significant multi-year cash-based retention bonuses with interim payment possibilities based on company performance; and an additional week of paid time off at a key project milestone for the team that surpasses expectations on project delivery. These actions can have little or no short-term cash cost and substantial long-term benefit to the company.

2. **Be flexible.** With many employees caught in cash crunches as a result of pay reductions in a time of soaring housing, energy, and food costs, some short-term relief efforts, such as interim payouts of the annual incentive program, might have high value to employees with no real incremental cost to the company. Consider instituting a short-term choice program. Allowing choice presents some risks, but if

an employer is willing to allow election of onetime cash awards in lieu of equity awards — given how little liquid value some of those awards have in current market conditions — it might be a win-win for the employer and employee. Buying back underwater options for cash through an option exchange program can provide a fresh start, lower overhang (if the repurchased options are retired from the plan) or replenish shares in the equity plan, and deliver some immediate pay value. In some circumstances, selling the underwater option obligation to a banking counterparty could raise cash to help fund cash payments. These short-term actions must be paired with a differentiated retention strategy, as discussed above, and ROI must be assessed.

- 3. Use soft dollars.** There are many opportunities for flexibility and value delivery in the use of the currency of “time and place.” With increased interest in flexible work schedules, many employees might welcome the opportunity for a partial cutback in work hours. Cutting back to 80 percent time, especially during the summer months, might appeal to many employees and reduce or eliminate the need for layoffs. Other workers might value an unpaid sabbatical with benefits continuation. Granting an extra week of time off (worth about two percent of salary), subject to blackout periods, in exchange for a five percent salary reduction also might be appealing to employees. Additional work-at-home days, if performance accountability allows, can reduce the cost of working to the employee without any cost to the employer.
- 4. Understand the financial priorities.** Companies that seem highly similar in terms of industry and size may have vastly different financial situations and capital structures and these differences will not be captured in survey data. While “profit” and “expense” may be the headlines under which compensation discussions are held, if short-term earnings are a lower priority than cash flow, consider changes that incur accrued expense now but pay out later. Similarly, understanding which form of capital, cash or equity, is more plentiful for the company can guide design decisions. Some of the ideas mentioned above conserve cash though lack an expense reduction benefit, which might be critical to survival during a downturn. Similarly,

many firms have record levels of cash, and shareholders prefer distribution of that cash rather than the additional ownership dilution of equity grants. Depending on the specific financial dynamics, consider hiring bonuses that pay out at the end of the first year rather than at commencement of employment, hiring bonuses paid in restricted stock units with one-year cliff vesting, or performance bonuses deferred another six months with a 10 percent premium paid for the delay or payable in restricted stock units with an additional 20 percent premium and six-month cliff vesting. Even traditional programs have opportunities for innovation: Convert the annual salary increase into a lump-sum bonus program with an additional one-year horizon (again, incorporating significant differentiation). Of course, such approaches need to be developed with careful attention to timing and structure because of the potential issues with deferral under IRC 409A. If it must be paid, find the least costly form and timing of that pay, using the chief financial officer’s definition of cost.

- 5. Measure the ROI.** Implementing compensation and benefit actions because “other companies are doing it” could be the wrong move for your company. For example, cutbacks in amounts of equity-based compensation at lower levels have some employers paying more to administer an award than the employee realizes in pay. Countless hours of management time spent “differentiating” 3.2 percent versus 3.6 percent salary increases need to be reconsidered. Every program has associated costs — administration, operation, communication, and management time — beyond the pay amounts and associated employer taxes. Calculating the all-in cost of

A recession can be an opportunity to innovate employee pay and achieve cost savings without sacrificing long-term value creation.

each pay program relative to the pay delivered and discontinuing low-return forms of compensation not only benefits the company but may free up pay dollars to boost other forms of pay. If it's costing \$50 per year per employee to deliver stock worth \$50, move \$75 into a cash bonus pool and bolster the opportunity for differentiation and flexibility while improving ROI, with \$25 dropping to the bottom line. Or, grant \$150 of stock to the top one-third of the performance distribution and redistribute administrative savings.

We recognize that some of these ideas are contradictory, and that is the point. None will work well for every company, but each will work well in a given situation. The goal is to understand the multi-year value impact of short-term cost saving actions and to implement an approach that balances the two. Despite the creative application of these ideas, however, a reduction in the workforce may still be necessary. But even that unpleasant action can be structured to reduce the costs associated with seeking those savings and derive the maximum financial benefit from the action.

In a recent article on innovative companies¹³, one chief executive officer said, "Many companies ... can skirt downturns entirely by coming up with innovations that change the game in their industries ... and during a recession, they invest." Whether these investments are improvements in the operation of existing programs or new approaches to delivering pay, we

believe there is opportunity in economic adversity, through innovation.

This *InsightOut* was originally published in May 2008 and has been revised to reflect the economic changes since that time.

¹ National Bureau of Economic Research, Business Cycle Dating Committee, December 11, 2007

² RSU: restricted stock unit

³ HSA: health savings account, a tax-advantaged medical savings account available to U.S. taxpayers enrolled in a high-deductible health plan (HDHP)

⁴ FAS 123R: Financial Accounting Standard 123 (Revised), which amended the rules for measuring and recording the expense associated with grants of equity-based compensation to employees

⁵ Section 409A of the Internal Revenue Code governs the tax treatment of nonqualified deferred compensation plans and arrangements

⁶ PPA: The Pension Protection Act of 2006

⁷ EESA: Emergency Economic Stabilization Act

⁸ ROI: return on investment, a broad term with many definitions but focusing on the measurement of the financial return associated with a particular investment

⁹ The National Bureau of Economic Research: one of the nation's leading economic research organizations

¹⁰ *Healing the Wounds: Overcoming the Trauma of Layoffs and Revitalizing Downsized Organizations*, by David M. Noer (John Wiley & Sons, 1993)

¹¹ "Halting the Exodus After a Layoff," *Academy of Management Journal*, April 2008

¹² "The war for technical talent," McKinsey survey, August 2000

¹³ "How Google Fuels Its Idea Factory," *Business Week*, May 12, 2008