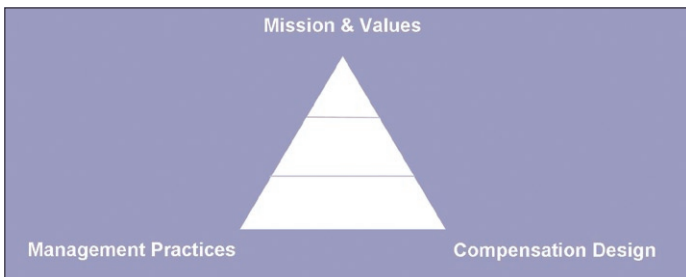




by Rick Flath

Designing Executive Compensation Plans: Attaining the Balance Between Risk and Reward

Everyday one reads newsworthy articles and editorials about executive pay, severance pay, investigations by Congress, and revolts by investors wanting to know if executive pay is fair and really related to performance. “Pay for performance” is the phrase most commonly used to explain a company’s compensation system. While everyone agrees that pay for performance is the “Holy Grail,” it implies that senior management take on risks and that pay levels should rise and fall with the company’s fortunes. The question is, “Can tribal councils and CEOs make an executive’s compensation more relevant to actual performance?” The design of an executive compensation program is to ensure the connection between pay, performance, and managing to promote and expand the interests of the tribe.



Annual Compensation

Is your organization’s compensation planning and design fulfilling the mission and values? Or is your compensation design merely reflecting the salary levels set by the last person who had the job and what the next person wants to be paid?

Typically, annual salaries are understood from the perspective of competitive analysis gathered through several industry salary surveys. This analysis reviews competition by comparing total revenue, numbers of employees, casino floor space, hotel rooms, return on invested capital and profitability (if available). Salary survey data is typically spread between 25%, 50% and 75% dollar amounts.

So the main question is, “Where does the casino want to be within this continuum?” This is as much a question of management practices and organizational culture as it is of cost. Most organizations blindly pick the 50th percentile, which of course means the average. So, when picking the average are you essentially agreeing to average performance, risk taking, etc.? However, if you adopt the 75th percentile, then the organization should provide sophisticated manage-

ment platforms for decision making, risk/reward tolerance, delegation, and responsibility that allows star performers to perform. And the organization should have significant performance metrics in place. The caveat here is if an organization gets the executive salary positions wrong, it effects the whole organization.

Annual Incentives

Annual incentives are born out of motivational theories stating that people in management are motivated by money (see Lynnea Brinkerhoff’s article “Creating and Sustaining a Motivated Workforce” p. 44-45 *Indian Gaming Magazine* February 2008). There is truth to these findings, however this type of motivation is usually very short lived and necessitates designing new incentives. Common performance measurements are target revenue, budget variances, turnover, and department goals. The typical bonus payout for executives is usually from 15-50% of annual salary. Consequently, if the salary is set inappropriately, most individuals work to meet the bonus criteria rather than the normal job criteria represented by their annual salary. Many incentive designs are not risk driven, but more bonus driven, i.e. paid a certain amount within a narrow range without any significant risk/reward leverages. In actuality, bonus amounts become “salary” and are a way that organizations “make up” poorly established salary levels.

If incentives are not connected to broader organization goals of mission and values, the likelihood of unintentional consequences increases. An example from a recent Wall Street Journal article notes that much of the sub-prime mess is due to fee structures and commission programs that reward the “deal” but not the ownership of the mortgage (Pleven, Liam & Craig, Susanne. “Deal Fees Under Fire Amid Mortgage Crisis,” *The Wall Street Journal*. January 17, 2008.) Consequently, historic credit standards became lax, and people with bad credit and lack of financial resources were offered mortgages. The reverberations have yet to be fully revealed.

Finally, organizations fail to acknowledge that not all senior managers’ responsibilities and job duties can be equally financially leveraged and some managers are just not motivated by money. Additionally, an improperly designed incentive plan, in which an executive’s job responsibilities are not aligned with the plan, may have no motivating effect at all on the executive’s performance.

It's not surprising, therefore, that senior managers leave, businesses do not meet expected financial targets, marketing plans fail, and company morale suffers due to executive turnover. Setting salary and annual incentive levels greatly impacts the success of an organization's mission, values, and business goals.

The Use of Tax Legislation to Provide Executive Benefits

Congress has used tax legislation to direct both individual and corporate behavior. A major way of accomplishing this objective is through deductions and credits. To this end, compensation experts, lawyers, insurance executives, and accountants have devised a dizzying array of programs. Commonly, these programs are based on tax deferrals and the attractiveness of compound interest. This concept is designed to allow the executive to balance both short-term and long-term decisions.

Qualified Versus Non-Qualified Benefit Plans

QUALIFIED PLANS: These play a significant role in the benefit packages of all organizations. However, the IRS regulates contributions and benefits and mandates that these plans be offered to all employees. This often leaves highly compensated executives and managers looking for other ways to save.

NON-QUALIFIED PLANS: The employer offers selected executives the opportunity to defer part of their current compensation. This deferred compensation is accounted for in a number of ways and when the executive retires, the business uses the money from this deferral fund to pay a retirement benefit. Non-qualified deferred compensation plans can supplement a qualified plan or serve as an alternative to one.

Non-qualified plans are easy to administer, and they do not require IRS approval. They simply require a formal agreement between the employer and the executive. The employer must also notify the U.S. Department of Labor.

Funding Arrangements

Typically, the value of accrued benefits has been left invested in the general assets of the business. Leaving plan assets in the business has the advantage of creating a source of funds (or avoiding a cash outflow), but it has several disadvantages:

- Unfunded liabilities are created that 1) must be recognized on the balance sheet if material, and 2) will result in a cash drain for future generations of management.
- Employees become general creditors who have, in effect, invested a potentially large portion of their wealth in an unsecured, undiversified, non-marketable security.

Summary

Designing effective executive compensation programs greatly affects the financial success and supports the mission and values of the enterprise. The integration of salary, incentive plans, and long-term deferred compensation arrangements, if designed effectively, promotes the mission/values and management practices. It is surprising how few organizations take the time to integrate the mission/values and attraction/retention programs into a dynamic executive compensation plan. The most successful companies seamlessly integrate all of the elements of compensation design, thus providing continuity and clarity to the organization, no matter who is in charge. This effort starts at the top of the organizational structure. ♣

Reasons Why Employees Appreciate Non-Qualified Plans

- Tangible benefits for employees
- Significantly increase retirement savings
- No contribution limitations
- Self-directed investment choices
- Significant tax leverage on benefits when received
- Flexible benefit payments (Access to funds: no early retirement or loan restrictions)
- Benefit portability
- Tax sheltered equity accumulations

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