The State of the Art in Annual Incentive Design for Executives

Highlights

from the 2001 Towers Perrin Annual Incentive Plan Design Survey

About the Survey

This report features highlights of Towers Perrin's 2001 Annual Incentive Plan Design Survey, which collected information on annual incentive programs for executives at 237 companies - primarily large, publicly owned U.S. companies in a wide array of industries. More than 40% of the survey participants are *Fortune* 500 companies. Participant companies recorded median sales of $4.1 billion, and the median number of employees was about 12,200.

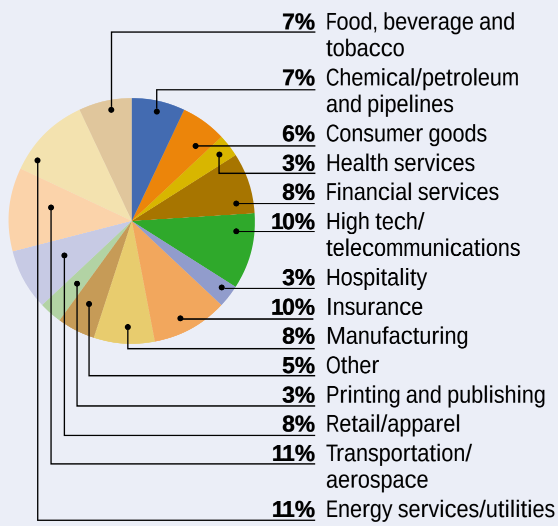
Survey participants receive a complimentary copy of the full survey report, which includes nearly 30 exhibits. Participants may also access the Annual Incentive Plan Design Database at any time to order custom analyses designed to suit their particular needs.

If you're interested in joining the Database, or have questions about its content, please contact your local Towers Perrin office, or Mike Adam at (312) 609-9487 or adammi@towers.com. For information on pay levels, long-term incentives or benefits, call (800) 645-5771 or e-mail tpdata@towers.com.

1 | Highlights

While companies continue to follow many common practices in their annual incentive programs for executives, they are also making use of a variety of sophisticated plan design features to make their compensation programs more effective. In this new study of 237 companies (see chart below), Towers Perrin provides a comprehensive look at the annual incentive design features prevalent today and identifies how some key practices have changed since our last survey, conducted in 1996.

Participants by industry



Companies are making use of a variety of sophisticated plan design features to make their compensation programs more effective.

Here are some of the report's key findings:

- There seems to be increasing conformity around certain common plan mechanics. For example, more companies are currently:
  - using a single criterion to determine eligibility under the plan
  - defining target bonus as a percent of base salary
  - using a *sum-of-targets* approach to determine aggregate award funding.
- Companies are now placing more emphasis on the process of setting performance expectations, considering a variety of factors when determining performance standards.
- More than half of the companies today incorporate the cost of capital into their incentive plans, either explicitly or implicitly.

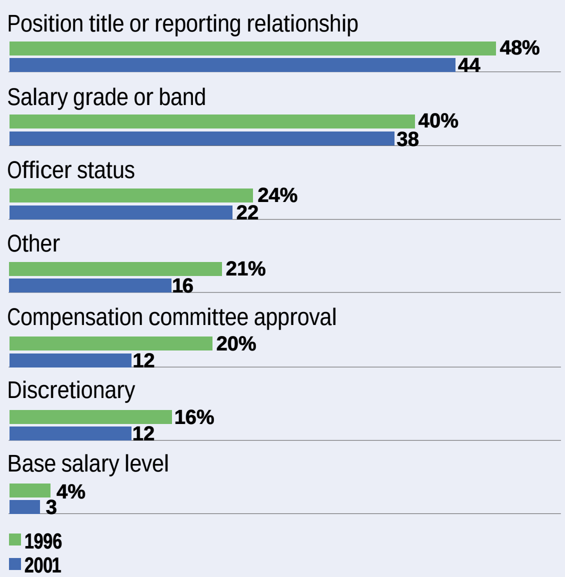
Here's a closer look at some of the major areas the study covered.

2 | Eligibility

This study concentrates on annual incentive plans that include the highest level of corporate management, typically the CEO and the company's senior management group. While there has unquestionably been a rise in broad-based incentive plans since our 1996 study, this study doesn't focus on these plans unless they include senior executives.

EXHIBIT 1

Basis for determining plan eligibility - 1996 vs. 2001



Percentages total more than 100% due to multiple responses

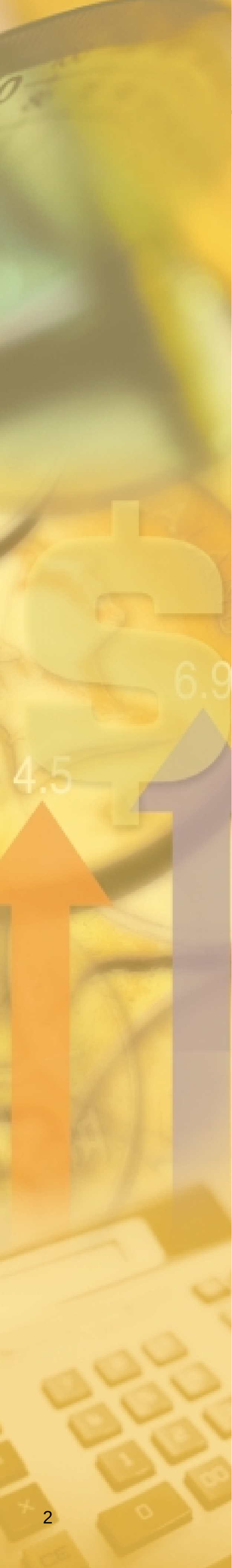
Eligibility for participation in the surveyed plans is determined at each company according to one or more factors, with title or reporting relationship being the most prevalent, followed by salary grade or band. While these findings are similar to what we reported in 1996, each category of criteria was reported by a smaller percent of companies in the 2001 survey, presumably because more companies are using only one criterion to determine eligibility instead of the multiple criteria used in 1996 *(Exhibit 1).*

In fact, nearly 70% of respondents reported that they use a single criterion for eligibility. More than one in 10 companies report that they use some subjective judgment, usually exercised by the compensation committee of the board or the CEO, to determine eligibility.

3 | Determining Aggregate Awards and Plan Funding

The method used to determine the aggregate amount of incentive payments to make in a given year is always of great interest because it is central to achieving a fair balance between the interests of many constituents (e.g., plan participants, shareholders).

Under the most widely used method, called the *sum of targets* approach, the aggregate amount of awards in a given year is determined by adding the target awards of all participants. This approach is used by 80% of survey respondents, with most companies modifying the pool derived from the aggregate targets by applying a formal schedule



relating to performance. Other companies using the sum-of-targets approach do not create a pool but instead determine the target bonuses and allocate them directly to the individual participants.

The second most common method of funding is to use a formula based on financial results, without direct regard to funding needs. This method is used at over 10% of companies, down from just over one-fifth of companies in the 1996 survey. The most common performance measures used in financial results-based formulas are earnings per share (EPS), operating income and return on assets (ROA).

Most companies establish a maximum total dollar amount to be paid under the plan each year. The most common method used is the *multiple of targets* approach, which is expressed as a multiple or percentage of the target pool. The most common multiple is 200% of target.

4 | Measuring Performance

Organizations are relying on increasingly complex methods to calculate their performance.

In the drive to improve measurement and make compensation practices more effective, organizations are relying on increasingly complex methods to calculate their performance. More companies are relying on two or more measures now than they did five years ago. In fact, nearly two-thirds of respondents reported that they currently use three or more performance measures.

Exhibit 2 shows that earnings per share is still the most commonly used performance measure, followed by sales/revenues, net income/earnings/profit, and earnings before interest and taxes (EBIT). About one-third of the companies reported that they assign a specified weight to individual performance (e.g., management by objectives, individual strategic goals). When an individual performance component is included in the bonus calculation, it is typically weighted about 25%. In other words, at the median, a CEO with an individ-

EXHIBIT 2

Prevalence of performance measures

	PERCENT OF COMPANIES USING*
Earnings per share (EPS)	**34%**
Sales/revenues	**25**
Net income/earnings/profit	**22**
Earnings before interest, taxes (depreciation/amortization) (EBIT/EBITDA)	**14**
Operating income/operating profit	**13**
Cash flow	**12**
Return on equity (ROE)	**9**
Pretax income	**9**
Return on invested capital (ROIC)/return on investment (ROI)	**8**
Customer satisfaction	**8**
Return on assets/return on net assets (ROA/RONA)	**8**
Other operating measures (e.g., operating margin)	**6**
Economic profit/Economic Value Added (EVA')	**5**
Employee satisfaction	**4**

*Percentages total more than 100% due to multiple responses ual performance component in his or her award has 25% of his or her bonus based on individual performance.

Over half of respondents reported that they assign weight to a non-financial measure, including individual performance and corporate non-financial measures. Customer satisfaction was the most commonly cited corporate non-financial measure. Companies using non-financial measures usually said they do so to support the execution of their business strategy or to reflect types of operational performance that cannot be readily distilled from a financial measure.

5 | Calculating the Award

Companies that use more than one performance measure have to define how the multiple measures will be combined in order to calculate an individual's bonus.

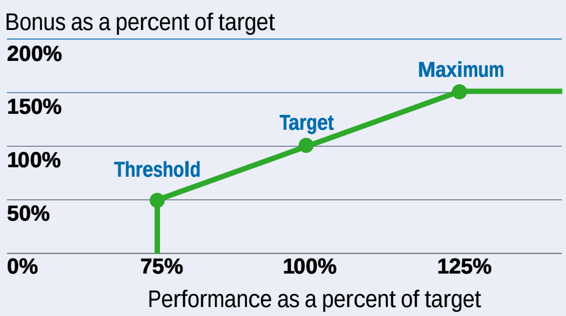
The most common way is an *additive* approach, which calculates performance separately for each measure and then adds the associated incentive awards to determine the final award. Under an additive approach, measures are more independent because an award can be earned for one measure and not for others. Almost three-quarters of respondents use this approach.

About 10% of respondents use a *multiplicative* method to calculate individual awards. Under this approach, performance under one measure is adjusted by performance under another measure. For example, a bonus calculated on EPS growth is multiplied by a factor based on a second performance measure (e.g., multiplied by a factor of 1.0 if the ROE target is met or by a factor of 1.25 if ROE exceeds target by 10%).

Our study also collected information on *performance incentive zones,* which represent the range of outcomes for which incremental increases in performance will result in incremental increases in bonus awards. *Exhibit 3* shows an example of this concept. The sizes of the performance incentive zones and the bonus payout ranges vary considerably among survey respondents. The median range of performance levels is 40%. In other words, the difference between threshold performance as a percent of target and maximum performance as a percent of target is 40%. The median (and modal) bonus payout range is 150%, indicating a payout range, for example, of 50% at the threshold level of performance and 200% at the capped, maximum level of performance.

EXHIBIT 3

Sample performance incentive zone



6 | Performance Expectations

Companies must also establish standards to identify what constitutes target performance and to assess the extent to which the target has been achieved. About two-thirds of all companies use more than one method to determine performance expectations, or standards, for their main performance measure. For example, a company may consider both the probability of achievement and investor expectations when setting performance targets for a performance measure. This is a big change from 1996, when only slightly over half used more than one method - usually targets solely with reference to the company's budget.

About two-thirds of all companies use more than one method to determine performance expectations for their main performance measure.

EXHIBIT 4

Factors that determine expectations for the *main* performance measure

Percentages total more than 100% due to multiple responses

As *Exhibit 4* indicates, while budgeted performance is still the most common standard, companies often consider incremental year-to-year growth, expectations of investors and assessments of current business conditions made by boards and management.

Optimism on achieving performance levels

When establishing levels of expected performance, companies face the challenge of finding standards that reflect both the need to achieve desired operating results as well as the probability of executing strategy and delivering competitive awards.

Not surprisingly, most respondents felt that their incentive plans should pay something in most years. At the median, respondents felt that they will meet the threshold performance level 90% of the time, target should be reached 60% of the time and the maximum level 15% of the time *(Exhibit 5).* These results are slightly more optimistic in tone than in the 1996 data - probably a reflection of the booming business conditions that prevailed until the middle of 2000.

EXHIBIT 5

Probabilities of achieving threshold, target and maximum performance

	THRESHOLD	TARGET	MAXIMUM
90TH Percentile	100%	95%	50%
75TH Percentile	100	80	20
Median	90	60	15
25TH Percentile	80	50	10
10TH Percentile	75	50	5
Mode	100	50	10

Growing interest in cost of capital

The survey shows that over half of companies are currently incorporating the cost of capital in their incentive plans, either indirectly through the budgeting process, or explicitly as one component of the performance measures or standards. That compares with 42% of respondents in 1996. Although there is no reported growth in the percentage of companies using explicit economic profit measures such as EVA® as a performance measure in their annual incentive plan, the percentage of companies using that and other measures incorporating the cost of capital has risen.

High payout levels

The most common level of bonus payout over the past five years was "between target and maximum," reported more often by companies than during the period covered by our 1996 study. However, it is notable that the percent of companies making no bonus payment at all increased over the five-year period, suggesting that the pay-for-performance model works both ways.

7 | Award Opportunities

Almost all companies calculate their bonus targets as a percentage of base salary. Among the organizations that limit the size of an individual's bonus, more than three-quarters define the maximum as a percent of the target bonus or of the base salary. The most common limit is the same as it was in 1996 - 200% of target.

Discretionary decisions are common

The percentage of companies that use discretion in awarding incentive payments is about the same. We found that just under half of the respondents allow individual award payments to be adjusted at the discretion of management or the board, although this practice has diminished since 1996. Generally, the CEO, board chairman and/or the compensation committee make these decisions, with involvement from the HR department and the individual's manager or supervisor.

Cash is still king

Virtually all companies make annual incentive payments entirely or mostly in cash. In fact, most companies (approximately three-quarters) *must* pay their annual bonus awards entirely in cash. One-quarter of those surveyed have a plan provision that *allows* bonuses to be paid totally or partially in stock. Less than half of these companies allow the executive to make the decision to receive stock in lieu of cash, while the majority leave the decision up to the company.

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Deferred payment arrangements are widespread

Over two-thirds of the survey group offer plan participants the opportunity to defer payment for individual tax planning or other purposes. In these situations, companies typically apply some method of crediting interest or appreciation to the principal. Our survey indicates that the most common method today is offering the executive a range of investment options similar to those available in a 401(k) account. This is a change from five years ago, when tying an interest rate to a variable rate, such as the prime rate, was the most common method.

Provisions for executives who leave

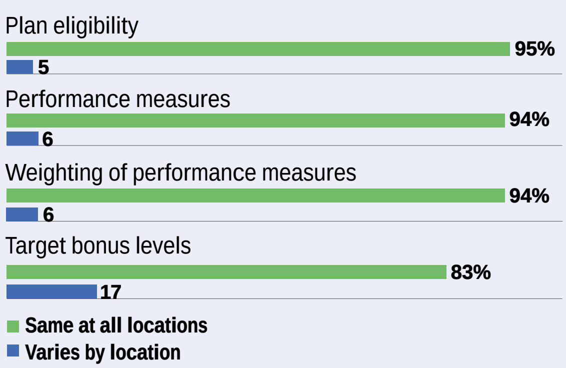
Most companies have policies for employees whose employment terminates during the plan year. If an executive leaves due to disability, death or retirement, most companies pay a pro-rated portion of the award. However, if the executive is fired or resigns, four companies out of five will not pay any bonus. If a person is laid off without cause (e.g., due to a downsizing), companies are split between paying a partial award, no award or making decisions on a case-by-case basis, with the most common choice being no award.

8 | International Issues

More than half of the companies surveyed include non-U.S. employees in the surveyed plan - an increase from the 1996 survey. Almost all of these companies use a similar plan design to deliver annual incentives to local and third-country national executives on a worldwide basis.

EXHIBIT 6

Administration of annual incentive plan at companies with non-U.S. executives



In annual incentive plans that include non-U.S. participants, the overwhelming majority of companies set consistent criteria regardless of location in four major categories: eligibility, performance measures, weighting of performance measures and target bonus levels *(Exhibit 6)*. The only significant plan feature that varies by location for executives is target bonus levels, and this practice was cited by only 17% of the companies surveyed.

9 | Plan Communication

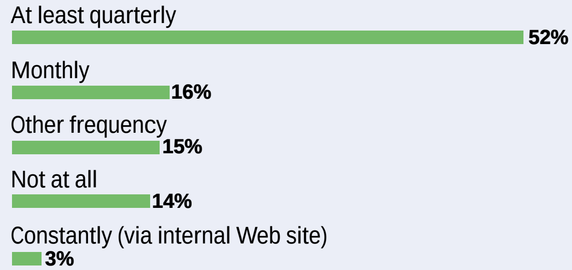
There's no question that even the best-designed incentive plan will be ineffective if its features aren't clearly communicated to employees.

By and large, companies indicated they communicate frequently with plan participants about their progress toward meeting annual performance targets. As shown in *Exhibit 7,* more than half of the organizations surveyed have these discussions at least quarterly, and nearly one in six reported monthly discussions.

Given the leadership role of senior executives, the size of the annual incentive plans and the important role that these plans play in aligning individual performance with shareholder objectives, frequent communication about progress toward meeting individual bonus targets plays a critical role in plan effectiveness.

EXHIBIT 7

Frequency of communication about progress toward meeting annual targets



About Towers Perrin

Towers Perrin is one of the world's largest global management and human resource consulting firms. We help organizations improve their performance by effectively managing their investment in employee benefits and other programs for rewarding people, including executive compensation. Additional services include HR technology, outsourced HR administration, and employee and organizational communication. The firm has more than 9,000 employees and 79 offices in 75 cities worldwide. More information about Towers Perrin is available at www.towersperrin.com.

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