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Compensation reconsidered: Making a human-centered approach pay off

Even before COVID-19 and the movement to address systemic racism, rapid changes in the nature of work were adding new demands and pressures on compensation strategies and programs. As a consequence, many organizations have been stuck in a seemingly endless cycle of compensation reviews, reforms, and rollouts.

For its part, the COVID-19 pandemic has put a spotlight on pay as it relates to essential work. Some organizations have raised minimum wages for essential workers; others have cut executive compensation to prioritize protecting employee salaries and jobs; and others have focused on retooling incentive compensation (see sidebar, "Incentive compensation: Keeping employees aligned with goals in a downturn").

As they navigate through these crises, however, organizations need to ask what principles should serve as the foundation for their compensation philosophy, programs, and policies going forward.

To do that, organizations should look beyond compensation as a "spot market"—focused on rewards to drive talent acquisition and retention—to viewing it as a lever to manage some of the biggest shifts happening in today's work environment. In this issue of *CFO Insights*, we'll examine some of those shifts, including changes in the way work happens (think remote work), the evolving expectations of the workforce, and the expanded role of organizations as they become social enterprises.

Assessing compensation drivers

Compensation—salary and wages—comprises the largest component of an organization's total labor costs,[1] accounting for up to 70% of overall costs,[2] including benefits. And yet, curiously, many organizations seem uncertain about how to approach this significant area of spend.

In Deloitte's 2020 Global Human Capital Trends survey, most respondents said that their organizations were either in the middle of redesigning compensation or had changed their compensation strategy within the last three years (Figure 1). What's more, 64% of respondents expected their organizations to redesign compensation yet again either this year or in the next three years.

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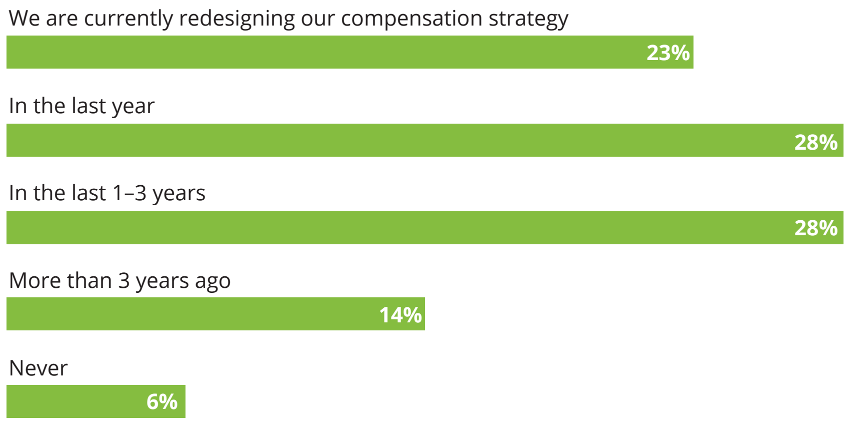
Figure 1: *When did you last redesign your compensation strategy?*
Most respondents are currently redesigning or have redesigned their compensation strategies within the last three years.



Source: Deloitte Global Human Capital Trends survey, 2020

Despite these continual efforts, our recent High-Impact Rewards study confirmed business executives' general dissatisfaction with compensation, as it garnered an incredibly low net promoter score: negative 15—the second-lowest score for any HR-related practice in any prior study by our research group, exceeded only by performance management at negative 60.[3]

The uncertainty about how best to approach compensation and the lack of positive results is not surprising, given the rapidly evolving environment that compensation strategies need to address.

For starters, there's the **radical shift in work and jobs**. Just consider the "half-life" of individual skills diminishing and entire roles changing as work is being redesigned to integrate human workers with robotics and AI.[4] Add to that the pandemic, in which work has been, and is likely to continue to be, shifted to being performed virtually (see "Remote control: How finance works, not where, matters most now," *CFO Insights*, June 2020). These radical shifts are highlighting the need for organizations to consider how better to remunerate their workforce for their skills and capabilities and create incentives that motivate the workforce to gain new skills and capabilities that will drive business results in the future.

Another big shift is the desire for **greater transparency** that is raising pressure on organizations as it relates to their compensation practices. A poll of workers in the United Kingdom found that 56% would support making their income and tax return information publicly available.[5]

And across the Atlantic, drivers for major ride-sharing companies launched strikes across the United States to lobby for better pay transparency.[6] Such calls for greater transparency reflect a growing sentiment that organizations should bear greater responsibility for answering questions about whether compensation works—and for whom.

Compensation fairness is another challenge in the era of the social enterprise. As the inequality gap widens,[7] external stakeholders are zeroing in on compensation and the idea of paying a living wage.[8] Compensation also remains a focus point to help address potential workplace bias and improve diversity-related outcomes. New research draws a direct connection between perceptions of compensation fairness and employer brand, employee engagement, and workforce well-being. One study of workers in Sweden finds that perceived fair treatment led to higher employee motivation and healthier lifestyle decisions.[9] Another study in the United States reports that women experiencing compensation inequity were twice as likely to suffer from depression and four times as likely to suffer from generalized anxiety.[10]

To navigate these challenges effectively, organizations need a new path forward that is anchored not only in data and benchmarks, but also on a set of principles that reflects the fact that compensation is more than a set of numbers—it's a reflection of how organizations value individuals and how individuals value organizations. Considering how much time and money organizations spend on compensation strategies, processes, and programs—and the total cost of wages and salaries—any change to compensation practices represents a significant decision that needs to put the human element front and center to have the desired impact.

Compensation 2020: The path ahead

To move beyond the compensation conundrum—the continual reconfiguring and tinkering with rewards packages of compensation, incentive pay, and benefits—in 2020 and beyond, business leaders and workers have the opportunity to reinvent compensation for a world of changing jobs, work, skills, expectations, and values. As a starting point for compensation's reinvention, we return to the five principles for human design we introduced in last year's Global Human Capital Trends: Purpose and meaning; transparency and openness; ethics and fairness; growth and passion; and collaboration and personal relationships.

We used this year's survey data to evaluate organizations' approaches to compensation against these principles. What we found was a series of gaps between how compensation is designed and executed today—gaps that we believe hinder an organization's ability to align compensation to the new world of work. To help organizations address them, we have proposed actions aligned with each of the five principles that we believe are mutually beneficial, enabling organizations to reward their workers in meaningful ways and transform that meaning into quantifiable value.

Incentive compensation: *Keeping employees aligned with goals in a downturn*

As a result of the COVID-19 pandemic and economic downturn, many companies have already taken steps to reduce compensation levels. Boards and management also face several challenges related to incentive compensation programs, including how to address unattainable annual incentive plans, adjust performance-based long-term incentives, and modify out-of-the-money stock options. To help drive employee engagement—and retain them at a time when they may be risking exposure to the virus to do their jobs—companies may want to consider one or more of the following changes to their annual and long-term incentives:

Options for annual incentives

- **Establish a new incentive plan with a shorter performance period.** Create an incentive plan that has quarterly or semiannual performance goals, but pay out the award shortly after the fiscal year has ended. Moving away from annual goals may serve as a motivator that rewards employees for achieving immediate business results that are a key part of the recovery phase.
- **Update the performance metrics.** Modify the type of performance metrics and corresponding payout opportunities used in the prior year's plan by placing less emphasis on financial performance metrics and more on qualitative metrics. Such qualitative metrics can include restarting facilities, collecting receivables, managing cash flow and debt, rehiring skilled employees, and restoring supply chains. This will help alleviate concerns about setting financial goals that are unrealistic during uncertain times.
- **Switch temporarily to a discretionary plan.** When it is too difficult to set realistic threshold, target, and maximum performance goals and corresponding payout opportunities, companies may want to consider switching to a plan in which overall company results, or three to five company performance metrics, are evaluated at year's end. Moving to a discretionary plan can help reduce the possibility of plan participants viewing an incentive plan as a demotivator during uncertain times.

Evaluating long-term incentives

In the face of stock market volatility, companies with distressed share prices may feel pressure to modify their long-term incentive programs. Management and boards may need to discuss these plan considerations:

- **Delaying equity grants.** It may be worth delaying annual equity grants until the market is less volatile or switching from a traditional annual equity grant practice to quarterly or biannual equity grants.
- **Calculating the size of equity awards using an average share price.** Given the current volatility, some companies may prefer to use an average stock price (e.g., a 60-day or 90-day average) rather than a spot price when calculating the number of shares to grant. This would help protect the company from overcompensating employees at the point when stock prices rebound.
- **Reevaluating the long-term incentive strategy.** Companies that utilize performance-based awards may want to temporarily switch to time-based restricted awards, which help alleviate the challenges of setting performance goals over a multiyear period.
- **Modifying outstanding-performance-based awards.** Companies contemplating modifications to performance-based awards with one to two years left in the performance cycle can consider changing performance metrics and lowering the threshold performance goals and corresponding payout levels.
- **Offsetting expiring stock options.** Companies may want to take an inventory of stock options that are set to expire this year and see how much value has been lost. With that, they can determine if a one-year, time-vested award should be provided to offset a drastic decline in stock price value. For employees who will be retiring or terminating, companies may consider allowing employees more than 30 to 90 days to exercise the award, perhaps extending the exercise period to 12 months.

The following actions offer organizations an enduring foundation in which to ground their compensation strategies to break the endless cycle of compensation redesigns:

Purpose and meaning

- *Value individual contributions.* With belonging rising to the top as one of this year's most important trends, it's critical that an organization's compensation strategy be effective at valuing individual contributions. Contribution—along with comfort and connection—is integral to establishing belonging and, ultimately, to aligning an individual to an organization's purpose.

Transparency and openness

- *Enable two-way input.* The world has seen continued growth in the power of the individual to affect organizations' reputation and brand and a rise in individuals sharing information traditionally kept private. Consequently, it is important to establish processes that not only establish transparency in the distribution of information, but also allow for an open feedback loop from the impacted individuals.

Ethics and fairness

- *Reward for expanded and changing responsibilities.* With automation and AI rapidly changing the nature of jobs, fairness can be determined based on how those shifts in role and responsibility are reflected in an individual's pay. This will demand a more agile process for evaluating job changes and rewards in tandem and with increased frequency.

- *Apply procedural and distributive fairness.* Technology has brought an increased focus on ethics at work. As the topic of ethics continues to permeate future of work discussions, it is important for organizations to have a consistent approach to how compensation is applied (procedural fairness), as well as a process for ensuring that work outcomes are rewarded consistently (distributive fairness) across all workforce segments.

- *Support a living wage.* As the social enterprise takes hold, organizations may be measured not only on shareholder value, but also on their impact on society as a whole. A broader set of stakeholders—including, but not limited to, employees—will likely have an increased focus on whether all workers are provided with compensation that maintains socially acceptable living conditions.

Growth and passion:

- *Pay for skills acquisition and development.* In a world where likely half the workforce may require significant reskilling and upskilling, organizations are missing a huge opportunity if they do not find a way to partner with workers to incent skill development—one of the most significant issues and potential barriers in the attainment of future business strategies.

- *Incent entrepreneurial behavior.* Workers can derive new value and meaning from work when they have the freedom and incentive to provide entrepreneurial and innovative ideas about how work can be done in the future.

Collaboration and personal relationships

- *Reward at the team level.* With a growing percentage of work being done in teams, the ability to set goals, motivate, develop, and reward at the team level is paramount to incenting behaviors that align with how work actually gets done.

By considering these principles, an organization can evaluate its compensation practices for their fit with worker needs and efficacy in supporting goals, such as worker development and marketplace competitiveness, as well as sustainability with respect to broader social norms and expectations. The desired end result: a compensation strategy that improves an organization's ability to accomplish its objectives while meeting stakeholder needs and expectations in a more transparent world.

Pivoting to end the compensation conundrum

Organizations are engaged in a constant cycle of adjusting and readjusting their compensation strategies in efforts to align compensation with changing talent and business challenges, including the current pandemic and economic downturn. We believe that this is because many are redesigning compensation in a reactive manner without basing their strategies on enduring principles that speak to the challenges organizations face today. Redesigning compensation this way can help organizations navigate an uncertain environment and make bold and effective forward-looking choices.

End notes

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