Procter & Gamble's Balanced Approach to Long-Term Incentives

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The fallout of the 2004 proxy season is a widespread de-emphasis on stock options. In their place, companies are either fully or partially adopting restricted stock or long-term cash plans, perceived to be more politically correct for these times of increased shareholder activism, a volatile economy and the imminent move toward the expensing of options.

A recent survey of early proxy filers for 2003 revealed that nearly one third were increasing the use of restricted stock for executives, in some cases partially or totally substituting restricted stock for options (Meyer, 2003). At lower levels, eligibility for options is also being tightened. Even where options remain, a pullback in participation and opportunities is evident across global locations, as some multinational companies move toward adopting more locally competitive incentive practices in their overseas operations.

There are many reasons for this shift. However, these reasons may not always reflect balanced consideration of both internal and external factors. A 2003-2004 survey of stock option practices of more than 350 U.S. public companies conducted jointly by Sibson Consulting and WorldatWork showed that changes to stock option practices in a period of 18 months have been driven primarily by external concerns relating to effects on shareholders and anticipated accounting changes. Internal considerations relating to attraction, motivation and retention of talent are less likely to be major factors in such decisions. (See Figure 1.)

Another recent Sibson Consulting survey of 23 consumer products companies confirmed this trend. More than 70 percent cited option expensing as a reason for their decision to change global equity programs, but only 24 percent cited talent-related concerns (Sibson, 2004).

However, one has to wonder if companies were to step back and take the time to pursue a thoughtful approach to long-term incentives (LTIs) rather than rushing to respond to the multitude of environmental forces, then companies, participants and shareholders could be better served. In some cases, shareholder alignment is deteriorating as organizations appear to lose sight of the goal of LTIs, namely to align employees' interests with the long-term performance of the organization, not to deliver short-term rewards. Taking the longer-term view, options actually may be very suitable for many organizations that currently have depressed share prices but good longer-term prospects for growth.

Therefore, instead of following the "wisdom of the crowd" and pursuing the next big LTI idea, organizations should take a broader perspective and consider the long-term implications of LTI changes on the workforce, the organization and its shareholders. Procter & Gamble (P&G) is one company that bucked the trend of discarding stock options just because other companies have done so. Instead, management considered what role LTIs, and specifically stock options, should play for their people in the future, in the United States and abroad, by using P&G business and people strategies as the basis for a balanced, full-scale review of their global LTI practices.

Taking a Holistic View of LTI Design

The fundamental reason for employing LTIs at any level in any organization is to align the interests of participants and shareholders, with the goal of achieving the long-term business objectives. In the authors' experience, retention is of secondary importance, as top talent can usually be acquired for the right price. The overarching aims for LTIs must be prominent at all times. Failing to base changes to LTI practices firmly on the company's specific business and talent needs, i.e. to attract, retain and motivate employees to achieve the business' objectives, will lead to suboptimization. Therefore, the most effective approach to LTI plan design is to look to the underpinning of the broader shareholder equation, which seeks to balance business and organizational strategy, talent implications, values and principles and financial

FIGURE 1 Factors Leading to Change

	2002		2003	
External Factors	**Minor Factor**	**Major Factor**	**Minor Factor**	**Major Factor**
Concern about the effects of option program on shareholders (dilution, overhang, etc.)	35%	32%	25%	56%
Anticipated accounting changes (e.g., FASB options earning charge)	Not asked in 2002 survey		25%	52%
Effects of public accounting scandals	15%	2%	38%	7%
Internal factors				
Value of options in attracting and retaining employees	31%	41%	52%	30%
Value of options in motivating employees	30%	42%	50%	31%

impact. (See Figure 2). This is the approach that P&G chose to follow:

FIGURE 2 Key Considerations to Balance in LTI Design

Business and Organizational Strategy	Supportive of the business strategy, organizational principles and culture
Talent Implications	Supports the attraction and retention of required talent
Values and Principles	Fair for both shareholders and for participants
Financial Impact	Aligned with financial responsibility to shareholders.

Addressing all these considerations as well as the external competitive landscape allows an organization to consider the myriad factors making up its own, unique situation in order to invest in LTIs for the largest return.

This article also explores how P&G applied this approach in its examination of global LTI practices. The company applied two fundamental compensation principles in guiding the review, to pay competitively and to support the business strategy. To accomplish this, P&G conducted a comprehensive review of its global LTI practices over a period of several months. The review, conducted in partnership with Sibson, encompassed the internal factors shown in Figure 2, balanced against an extensive competitive assessment conducted by another major global consulting firm. The study also included a tailored study of planned future LTI changes at peer companies. This "future scan" ensured current competitive data was interpreted in the context of future market direction.

Business and Organizational Strategy

Align Proposed LTI Practices with the Strategic Business Direction

It would be a fair bet that any successful organization has actively adjusted its business strategy to some degree in the last few years as it moved toward new markets, merged or matured from a startup to a more established operation. P&G was no exception. Four years ago, it realigned the business under global brands and sharpened its focus on providing the highest value to customers. In doing so, the company set itself on a path to spark further product innovation and deliver record growth in both established and developing geographies. The strategy has paid off. During the last three years, P&G has delivered shareholder returns of 81 percent, achieved EPS growth of 125 percent and increased net sales from $40 billion to $51 billion.

Considering that the goal of any LTI plan is to lead and/or support the strategy as it changes, strategy should be the key driver and ongoing reference point for any plan changes. An organization must ensure that each area of design and mechanics is linked to the business strategy, as outlined in Figure 3 on page 9.

Linking plan design to the business strategy aligns participants' motivation with the strategic imperatives of the business. Communication about the linkage can then be used to reinforce the strategy and clarify the intent of the LTI vehicles. For example, a young outsourcing business was acquired by an investor who wanted to drive significant growth before an anticipated future exit. The new CEO switched from a cash-based LTI to a phantom equity plan. The CEO reinforced the link between the plan and the business strategy at quarterly communication meetings with staff, explaining the business strategy, the impact of individual performance on the value of the company and resulting rewards from the LTI plan based on performance. The clear communication increased motivation and drove the behavior required to achieve the business strategy by increasing understanding of how the business operated.

Align Proposed LTI Practices with the Organization's Culture, People Strategy and Rewards Strategy

In addition to the business strategy, LTI design must align with the organization's people strategy. Typically the people strategy reflects the business strategy (e.g., an investment bank with an aggressive growth strategy is likely to have a strong performance-oriented culture and rewards framework), but also contains more direct detail about how the organization wants to interact with its employees. Figure 4 highlights some of the key questions that help in this analysis.

When P&G revisited its global LTI designs, it carefully examined its people strategy to ensure that the revised LTI plans would reflect the company's "build from within" approach to talent management and the need for mobility of key people across the organization. Management also wanted to maintain the company's stature as an "employer of choice" by offering attractive, competitive opportunities for long-term wealth creation across all global locations.

FIGURE 3 Aligning Plan Mechanics With Business Strategy

Design Element	LTI Design Considerations
Eligibility	• Is the plan focused on the individuals who will be key to the organization achieving its goals?
Performance Measures	• Are the performance measures of the LTI plan the best quantifiable measures of the key strategic drivers of the business, e.g., if the strategy is to outperform a peer index, are LTI awards linked to the organization's performance against that peer index? • Do the measures send the right messages about what's important?
Performance Period	• Is the performance period aligned with the timeline of the strategy, e.g., for returns to investors, or the achievement of specific business goals?
Target Setting	• Do the LTI plan targets reflect the objectives outlined in the business strategy on the following dimensions: - Relative versus absolute - Versus plan/budget; standard or improvement over prior year - Use of thresholds - Modification of goals mid-term.
Award Size/Funding	• Are award opportunities commensurate with the degree of performance increase required to achieve the strategy, i.e., the bigger the required step-change in business performance, the bigger the award opportunity should be for executives who successfully drive that performance?

FIGURE 4 Aligning Plan Design With People Strategy

People Strategy Considerations	LTI Design Considerations
Talent Profile	• Who are the people that the company needs to achieve its goals? - What is their profile? - Where will they come from? - What skills will they need to be successful?
Culture	• How well do the compensation vehicles align with the culture the organization is trying to perpetuate or create?
Pay Prominence	• What role does pay, and specifically LTIs, play in the people strategy? • Will LTIs increase/decrease in prominence under the proposed arrangements?
Receptivity to Change	• How do participants typically respond to change? • What is the risk of change at this time? • Do participants like/value the current LTI design? - Would participants most likely recommend tweaking or whole-scale redesign?
View of Current Design	• How would a change in the compensation program change the employee value proposition?

Talent Implications

Any changes to LTI practice need to reference the people strategy, as outlined above, to ensure that rewards are focused on attracting and retaining those employees who have the most impact on driving the organization's performance.

To assess whether LTI plan changes will cause turnover or demotivate participants, the organization needs to analyze the differences in the rewards deal offered to employee populations under the previous LTI plan versus the proposed plan. Sibson's 2003 *Rewards of Work* study shows that the reasons people join and stay with a company are broader than compensation alone, including the full range of reward offerings, often referred to as the employee value proposition (EVP). (See Figure 5.) In changing LTI practices, a company is potentially changing two key areas of its EVP, direct financial rewards and affiliation. Analysis of the impact on the direct financial component needs to include comparisons of levels of LTIs under the new plan versus the old plan for the population as a whole and for different segments, and also whether the rewards are competitive. Affiliation analyses should consider the role of pay in the culture, e.g., whether the LTI plan changes have an impact on affiliation by introducing or removing ownership opportunities.

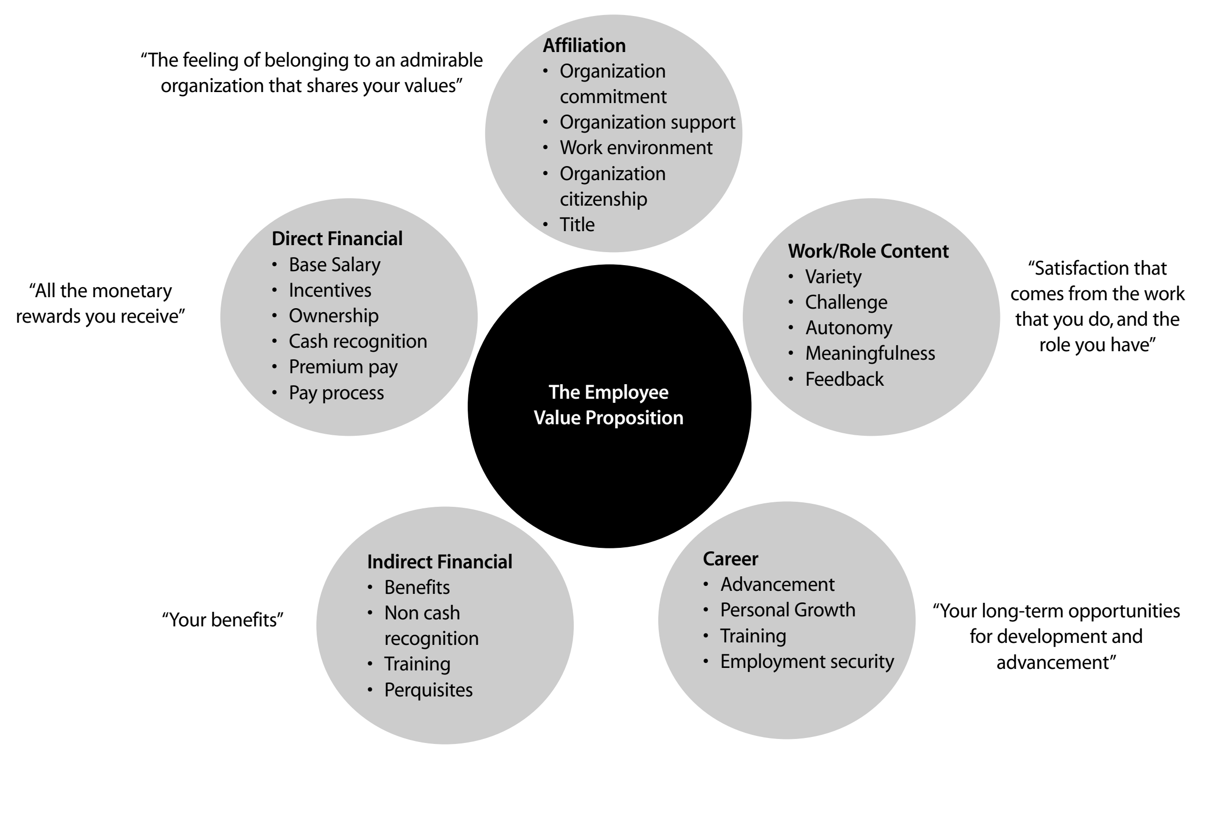
P&G approached the talent issue by focusing on the impacts on different groups' EVPs, e.g., different salary bands, employee groups and key growth geographies. By conducting a comprehensive analysis of both the overall impact and impact by segment, P&G was able to fully understand the implications of any changes on critical populations.

Values and Principles

An organization's LTI plan must be perceived as fair both for participants and, as increasingly publicized, for shareholders.

For participants, this means ensuring that LTI practices are aligned with the rewards strategy; they are equitable and clearly communicated. The plan should adhere to a clearly articulated rewards strategy, which allows the board and management to make decisions about pay levels and plans within a mutually agreed upon, transparent framework that is operated in the interests of both employees and shareholders.

FIGURE 5 **The Employee Value Proposition (EVP)**



Employees should be aware that the reward strategy is the basis for their compensation levels. Any changes to plans or practices should continue to adhere to the guiding principles that employees understand and expect. For example, as mentioned previously, one of P&G's guiding principles was to pay competitively and fairly across all global locations.

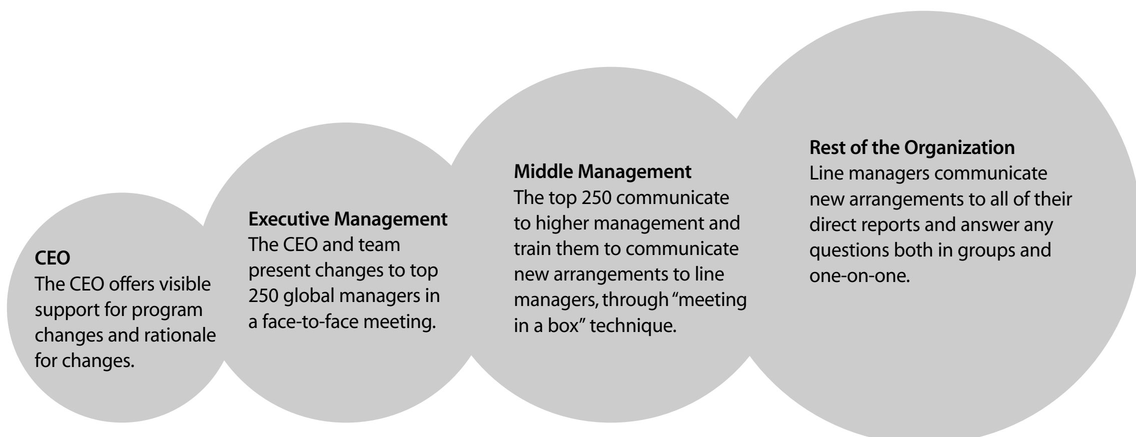
Equity across different areas of the business is a key consideration in global organizations. With LTI participants in more than 70 countries, P&G needed to ensure that its new LTI practices were perceived to be fair worldwide. This involved balancing the need to pay competitively in each location with the need to ensure the right degree of calibration across global P&G teams and the right level of individual recognition. Accordingly, the LTI design team addressed three questions: Will any changes affect the desired degree of employee mobility across countries? Might any changes affect collaboration across business units and geographies? Are top performers and other key individuals receiving rewards commensurate with their contributions?

Both the philosophy and rationale behind the plan and its mechanics should be clearly communicated to participants. Clarity about the rationale behind the plan can increase participants' understanding of the business strategy. Clearly communicating the mechanics of the plan can ensure that employees have line-of-sight, and understand how their actions impact the business and, in turn, their incentive payouts.

P&G's approach was to cascade communication about the new compensation arrangements and the rationale underlying these changes to the entire organization. (See Figure 6.) The communication goal was to share the facts with employees on an "adult-to-adult" basis, outlining the strategic business rationale for the compensation plans, including the thorough analysis behind the plan design. Communication cascaded from the top of the organization: management had ownership for communicating the implications to its teams. The result was a better understanding of the business strategy that the incentive plans supported and increased buy-in among all levels of employees affected by the new compensation arrangements.

One of the best ways to objectively examine the fairness of LTI plans from a shareholder perspective is to measure how closely historical LTI practices have aligned with shareholder interest by analyzing the relationship between pay and performance. This analysis plots

FIGURE 6 **A Cascade Communication Process**



It is becoming increasingly common for shareholders to have the final say in whether LTI practices are acceptable.

actual historical incentive payout levels against shareholder returns to analyze the degree to which past total pay levels have aligned with performance (equity with long-term performance, annual incentives with annual performance) and thus are defensible with varied constituencies. The stronger the correlation between shareholder returns and payout levels, the better the alignment with the returns delivered to shareholders and employees. The analysis can help determine whether elements of compensation are appropriately structured to ensure future pay alignment and consistency with the compensation philosophy (e.g., target pay levels, mix of pay components, leverage of variable pay programs).

Financial Impact

Once an organization has begun to narrow down potential LTI vehicles and practices based on the first three considerations, the alternative designs need to be evaluated for financial impact.

Financial impact encompasses the economic costs of the proposed LTI plan, including the impact on cash flow, dilution and unwanted turnover. It also includes the accounting costs and impact on the profit and loss statement (P&L) at year-end. While financial impact is an extremely important consideration, companies too often focus on financial impact to the exclusion of the factors discussed, as the widespread move away from options in response to the anticipated requirement for expensing options attests.

Companies can gauge what is reasonable in terms of financial impact by analyzing what is affordable for the company and for shareholders. The first step is to thoroughly analyze the sensitivity of the proposals under different business performance scenarios. These might examine possible maximum payouts if performance expectations are exceeded, target total payout cost to the organization, and comparisons of total payouts and the associated dilution with historical and peer LTI expenditures.

P&G fully explored all of the financial implications of different design alternatives, but balanced the findings regarding financial impact with all of the other considerations discussed, which ultimately led to an LTI design that was financially responsible but responsive to the company's business and people needs. This balanced approach was key to the program's ultimate acceptance by participants.

As a final consideration, it is becoming increasingly common for shareholders to have the final say in whether LTI practices are acceptable. Approval can be explicit, e.g., the requirement to gain shareholder approval of all equity grants, or implicit, such as shareholders expressing their opinions about management decisions, including pay practices.

Shareholder acceptance should be discerned as part of the LTI design review and analysis. Most major commercial investors have guidelines that detail their expectations and preferences for the businesses in which they invest. These guidelines may outline views on risk, debt or the key measures of the organization's health that they want to see preserved. They may also contain expectations relative to shareholder dilution through equity plans and other incentive design preferences. By considering investors' views and presenting a business case and financial impact for the plan proposals, an organization can win over its shareholders. Investors are likely to approve a plan that is designed to drive performance improvement and yield tangible results.

Finding the Balance

Balancing all of the considerations that impact LTI design can prove challenging. The following four steps identify the critical success factors for LTI redesign.

1. Create a scorecard to balance all of these considerations and present the overall picture. An effective way to consider all of these factors is to set them out in a summary scorecard. P&G used such a scorecard to measure the potential effectiveness of different design alternatives against each key consideration. (See Figure 7.)

2. Be cognizant of any unintended consequences of your chosen design. In addition to examining strategies, talent, values/principles and financial impact separately, organizations must remember that these considerations form a "seesaw" where each area impacts the others. For example, an organization that leans toward saving money from a financial perspective may have implications on the levels that can be offered to specific individuals and, hence, talent strategies. Therefore, the analysis must consider the intersections and impacts of each factor upon another.

3. Explore any variations in impact on different populations. Organizations must consider whether proposed practices affect different levels within the organization in different ways. If so, the design must reconcile these differences. For global organizations, the issue may hinge on how to achieve their strategic objectives while offering different LTI levels across different geographical areas.

4. Consider longer-term implications and needs. Finally, it is important to consider what is right for the organization, its employees and shareholders, not only in the short-term but also in the immediate future, to minimize the chance that practices will need to be revisited again soon.

Final Thoughts

The current environment represents both challenges and opportunities related to LTI design. Companies can position themselves to address the challenges and take advantage of the opportunities by taking a holistic

FIGURE 7 **P&G's Balanced Scorecard for Long-Term Options**

Consideration	Key Concerns and Questions
Business and Organizational Strategy	• Does the solution support our business strategy? • Does the solution hinder the company's ability to manage the business globally? • Are we restricting our ability to maintain our "build from within" culture? Are we compromising our goal to be an employer of choice?
Financial Impact	• What are the financial and economic costs in comparison to our current program? • How are changes likely to be viewed by shareholders? Do they align with investor's guidelines?
Talent Implications	• What is the impact of the changes on the employee value proposition for different employee groups across geographies? • How exposed is the business to the loss of key talent, especially in key geographies? • Will the change impair employee mobility across locations? • Might any changes affect collaboration across business units and geographies?
Values and Principles	• Are the changes consistent with the company's values and principles? • Are the changes consistent with the guiding principle of paying competitively and fairly across all global locations? • Do the changes support and reinforce those principles that are the foundation of the compensation strategy?

approach to the LTI design process, incorporating not only traditional design considerations such as competitive practices and financial impact but also the internal considerations such as business imperatives, culture and values that make each company unique. In so doing, companies can be more assured of solutions better customized to their specific circumstances, better manage against unintended consequences and lay the stage for a well-supported implementation.

The process P&G engaged in did just this, highlighting the following key success factors:

- Avoid overweighting competitive trends and underweighting your internal business and talent needs in your review and decision processes.
- A rigorous and thorough fact base builds confidence and helps ensure a given solution makes sense for your company.
- A systemic review framework supports tough decision-making.
- Bringing the CEO and senior leadership team to the point of decision should involve multiple progress reviews.
- The CEO and senior leadership team need to take a visible role in decision-making and rollout to reinforce how any changes support the business and organizational strategy.
- Even in the event of a takeaway, a principled and value-based approach allows for "adult-to-adult" conversations.

Ultimately, P&G came to a design that was aligned with its business and people strategies, responsive to its specific talent needs, consistent with the companies' values and was still financially responsible for shareholders. In the end, being true to your company's unique business and talent needs — while staying cognizant of external trends — is the only way to develop effective compensation plans, and if done right, can lead to compensation designs that create competitive advantage. WJ

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