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The CFO: HR's New LTI design partner

Five Recommendations for Successful Collaboration

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During the past several years, long-term incentive (LTI) plans have evolved from simple grants of time-vested stock options to more complex portfolios of equity and cash-settled vehicles. This increasing complexity underscores the need for effective collaboration between HR and the chief financial officer (CFO). Sibson Consulting interviewed more than a dozen HR/compensation executives from across the country to discuss their experiences in working with the CFO, specifically as an LTI design partner. Five recommendations for effective collaboration emerged.

QUICK LOOK

- Long-term incentive (LTI) plans have evolved from simple grants to more complex portfolios.
- Recommendations for successful collaboration include developing financial acumen, and identifying and involving stakeholders early.
- The connection between HR/compensation and the CFO (and finance team) may evolve slowly.

The New Context for LTI Design

The era of "no-cost," time-vested, plain-vanilla option grants as the single LTI vehicle is over. (See Figure 1.) Three shareholder imperatives suggest a more complex LTI portfolio design:

- **Pay for Performance.** Link incentives to meaningful performance metrics that drive shareholder value creation.
- **Economic Impact.** Diligently manage company cost and shareholder dilution.
- **Risk Avoidance.** Mitigate the potential for unintended negative consequences, either financial or regulatory.

Interviewees believe that these demands require human resources to collaborate with the CFO and the finance team in plan design. In their experience, successful collaboration leads to more creative LTI portfolio design with increased rigor and responsiveness to shareholder demands. "You shouldn't do LTI portfolio design alone anymore," agreed the HR/compensation experts Sibson interviewed. "There's just too much at stake."

Successful Collaboration

In our interviews with the HR/compensation executives, Sibson asked about their recent experiences in LTI design. While all agree that collaboration with the CFO is essential, the CFO's prominence in the process varies. "Once they [finance] figured out we weren't doing anything that could hurt the company financially, they pretty much left the design to us," said one interviewee. On the other hand, another noted, "The CFO was involved in every meeting. He was very concerned about the metrics we chose and the cash-flow implications of our design." There is clearly a spectrum of design collaboration, which ranges from HR dominating the process to the CFO/finance taking the lead. Regardless of where on the spectrum a company falls, five recommendations for successful collaboration consistently emerged:

1. Develop financial acumen.
2. Identify and involve stakeholders early.
3. Assign stakeholders specific responsibilities.
4. Apply a multiperspective mindset.
5. Forge long-term relationships. (For examples of application of the recommendations, see the WebExtra "Success Stories.")

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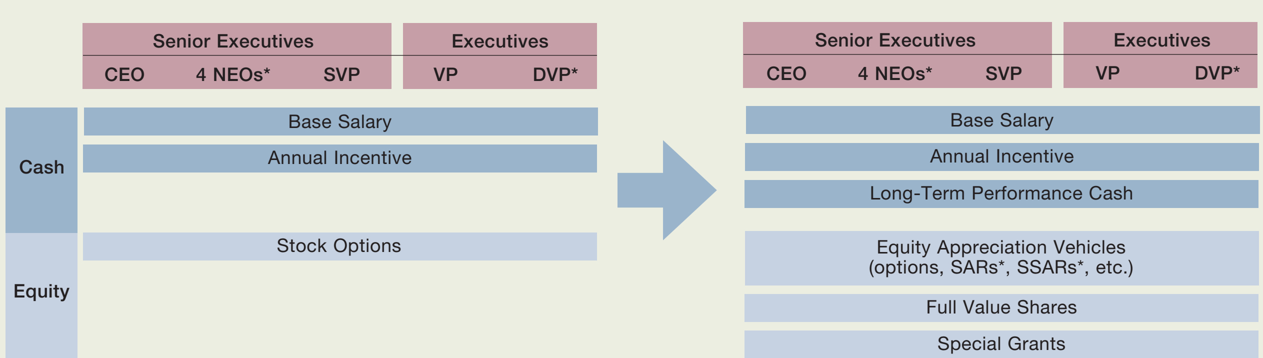
FIGURE 1: COMPANIES HAVE REPLACED THE TRADITIONAL LTI APPROACH WITH A PORTFOLIO DESIGN



* NEOs = named executive officers; DVP = divisional vice president; SARs = stock appreciation rights; SSARs = stock-settled stock appreciation rights

Source: Sibson Consulting

FIGURE 2: ACCOUNTABILITY MATRIX

	HR	Finance	Legal	Senior Leadership Team	Comp. Committee
Develop the go-forward compensation philosophy	Recommend			Consult, Approve	Consult, Approve
Select long-term incentive vehicles	Recommend	Consult	Consult	Approve	Approve
Determine performance metrics and vesting provisions	Consult	Recommend			
Set performance targets	Consult		Recommend	Approve	
Develop plan governance and oversight structure	Recommend		Consult	Approve	Approve
Develop plan documentation and filings	Consult	Consult	Recommend		Inform
Develop internal communication plan	Recommend	Consult	Consult	Approve	Inform

Source: Sibson Consulting

Recommendation No. 1: Develop Financial Acumen.

"I think that one of the greatest barriers for collaboration between HR/compensation and the CFO is that we don't speak the same language," said one interviewee. "All business is driven by numbers. HR can talk about the 'people drivers of business' all it wants, but unless you understand the financial intricacies, your designs won't have the impact they should." Another interviewee expanded on the importance of financial acumen: "You don't get 'comp. versus the CFO' if you understand the finances of the business. Do your homework, check out 10k's, understand what drives your stock price. You have to get to the point where you are as credible to the CFO as an outside consultant."

The interviewees recommend that, at a minimum, HR understand financial concepts and terminology, such as total shareholder return, cash-flow volatility, earnings per share and return on investment (ROI). They also urge HR professionals to know how to "read" their company's income statement, balance sheet and cash-flow statements. Finally, with an eye toward winning shareholder approval for additional equity, "You need to understand how ISS and Glass Lewis do their calculations and how your company would measure up," said one interviewee.

Unless you understand the financial intricacies, **your designs won't have the impact they should.**

A 25-year veteran of compensation design summed it up like this: "A working knowledge of these key financial concepts and their application in your organization helps facilitate productive conversations with the CFO and, as a result, effective outcomes. Comp. people need this strong underpinning in the business. They need to understand that we're not in the happiness business. If you want that, join a circus."

Recommendation No. 2: Identify and Involve Stakeholders Early.

While HR/compensation and the CFO may be the principal protagonists in the LTI portfolio design, the interviewees suggest that there are other stakeholders that need to be involved early for the design to succeed. "The board and compensation committee want to know that the CFO has had a smell test, that the GC [general counsel] is OK with it, and that the CFO and the head of compensation are singing from the same song sheet," said one company's head of compensation.

FIGURE 3: HR AND THE CFO LTI DESIGN OBJECTIVES ARE DIFFERENT

	Illustrative Concerns
HR/Compensation	• Desired business outcomes
	• Economic impact to the employee, including competitiveness of LTI package
	• Retentive characteristics of vesting provisions
	• Employee line of sight to performance metrics
CFO/Finance	• Linkage to business strategy
	• Cash flow implications
	• FAS 123R treatment of vehicles and vesting provisions
	• Alignment of metrics with "The Street's" perspective
	• Dilution/Overhang
	• Tax consequences to company

Source: Sibson Consulting

He emphasized the importance of communication with all stakeholders early in the LTI portfolio design process: "You don't want to get midway through the project and realize that legal should have been reviewing a certain plan provision months ago." The need to organize each stakeholder's involvement in the design process leads to the third recommendation.

Recommendation No. 3: Assign Stakeholders Specific Responsibilities.

Interviewees point out that even with an "ideal" collaboration between human resources and the CFO, the LTI portfolio design process can get derailed. "Everyone seems to have an opinion," said one. A strong recommendation of the interviewees is to organize and stage the expected participation of all identified stakeholders. "You want to make the highest and best use of each of the key resources for the design process and to avoid unnecessary conflict or duplication of effort," said one interviewee.

While a list of stakeholders and their responsibilities does not have to be as formal as the accountability matrix in Figure 2, all stakeholders should know what is expected of them throughout the design process. "At the very beginning, even before we talked about objectives for the LTI plan, we agreed upon what we called a Decision Rights Matrix," said one interviewee. "We even attached a timeline to it. Everyone knew their role and when they were expected to 'perform.' If someone started to get into things they shouldn't, the CFO and I pointed to the Decision Rights Matrix."

Recommendation No. 4: Apply a Multiperspective Mindset.

HR and finance professionals bring very different business perspectives and design objectives to the LTI portfolio design process. "We in HR want a design that engages and retains the executive as well as focuses the executive on the behaviors and actions that lead to desired business outcomes," said one interviewee. "Finance focuses on the enterprise economics and regulatory issues." (See Figure 3.)

The interviewees suggest effective collaboration requires a deep understanding of and willingness to incorporate HR and finance perspectives. They note that in organizations where human resources alone designs the LTI program or dominates the design process, plans focus on retention, attraction and "competitive practice in our industry." On the other hand, in organizations where the perspective of finance dominates, the outcome frequently is "the least expensive" alternative. (See Figure 4 on page 44.)

> "We in HR want a design that engages and retains the executive as well **as focuses the executive on the behaviors and actions that lead to desired business outcomes.**"

The interviewees affirm that the best LTI portfolio design reflects a respect for the different perspectives of human resources and finance and a balanced resolution of those perspectives.

Recommendation No. 5: Forge Long-Term Relationships.

The connection between human resources/compensation and the CFO (and finance team) may evolve slowly.

FIGURE 4: FINANCE AND HR EACH APPROACH THE PROCESS WITH DIFFERENT DESIGN PERSPECTIVES

Spectrum of LTI Design Perspectives

HR-centric Perspective	Target Positioning	Finance-centric Perspective
"We were so focused on questions like, 'How is this going to affect turnover?' It really took finance to show us the realistic financial constraints we faced."	"We made our concerns known, but we found that we were most effective when we could present analyses that addressed the CFO's concerns at the same time."	"Finance opted for the least expensive approach rather than focusing on the broader topics. We had to keep asking, 'Is this motivational? What does this mean for the individual?'"

Source: Sibson Consulting

The interviewees suggest that the time to start is long before there are issues to address or a crisis develops. "You've got to start out right away to build bridges," said one. "Show the CFO that you are a great business-person first and understand the finances of the company. You just happen to work in compensation."

Even the most seasoned compensation professionals Sibson interviewed admit that it can be a challenge to forge these relationships. "I was at one company where the CFO welcomed the relationship. We built some great programs together," said one interviewee. "At the next company, the CFO saw only silos. I didn't think I was very effective in my compensation role. Where I'm at now, I've been able to really nurture the relationship with the CFO and his team. They know that I understand in depth their perspective and concerns, and they have a good deal of respect for my comp. skills. We do great things together."

Unanimously, the interviewees believe that the outcomes that result from a collaborative relationship with the CFO (particularly in LTI portfolio design) are worth the effort expended. "You need to have this relationship for survival," commented one. "Otherwise, you're doing a trapeze act without a net. The CFO can champion the cause or be the biggest obstacle."

Conclusion

Changes in LTI practices as well as accounting and regulatory requirements create the need for HR to collaborate on LTI portfolio design with a new design partner — the CFO. This can be an uneasy collaboration. The five recommendations of seasoned HR/compensation executives can facilitate the desired ultimate outcome — an LTI program that meets shareholders' demands and is a strategic, financial and cultural fit with the company. WS

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WEB EXTRA

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Success Stories

Success Story No. 1.

Key long-term incentive (LTI) performance metrics for an expansion-focused U.S. retailer were the number of new stores opened and total revenues generated. The plan drove a "growth at all costs" mindset. For many years, the strong economy and lack of competitors supported this growth. However, with a slowing economy, it was taking longer for new stores to become profitable. Overall, return on investment (ROI) began to decline. The company's stock lost its "market darling" status and also declined in value (a double whammy for executives since LTI awards were denominated in stock units).

The chief financial officer (CFO) and the vice president of compensation had enjoyed a strong collaborative relationship. Over the years, they had discussed the importance of a strategic focus on profitability and growth as well as the need to increase shareholder value. They also agreed that ROI should be a key metric.

Resistance to a change in metric for the LTI plan permeated the executive ranks. "Without the CFO as a champion of the change in measures and plan redesign, we would still struggle to drive the 'right' behaviors," said the vice president of compensation. "Our CFO has a good deal of credibility with the people at the top. He gradually educated senior leaders and the board about ROI and profitable growth. Later, when I came in to present the new plan design and metrics, they were very receptive."

Three years later, the company's executives have evolved from a "how much can we grow" mindset to one that reflects "how profitably can we grow?" The company again is a "market darling."

Success Story No. 2.

A leading financial services company needed to use its LTI plan to attract and retain talent in an increasingly competitive market. Unfortunately, the company's reserve of options — historically the vehicle of choice — was running low, and demanding investors were reluctant to authorize more shares. The company realized it would need to shift toward a portfolio approach that also would rely on full-value shares and, in particular, cash, to deliver a competitive opportunity. While the path seemed clear, the road to change would not be easy.

From the beginning, human resources focused on the continuation of the ownership characteristics of stock options. Therefore, it favored a cash-award component that would appreciate with the stock price. However, the CFO was primarily concerned with expense volatility. He believed the expense tied to such a cash award would be far too unpredictable for the company's income statement. In the end, human resources and the CFO were able to diffuse the tug-of-war through a series of meetings in which each side clarified its objectives and developed a better appreciation for each other's concerns.

Ultimately, human resources and finance were able to collaborate on a creative solution based on performance phantom-cash units. The plan balances human resources' and the CFO's concerns by basing the value of the units on a trailing 12-month market value and placing limits on the upside and downside associated with the award. As the head of human resources put it: "HR wanted to preserve the 'ownership' culture; the CFO cringed at the expense volatility. We had to depersonalize the situation in order to find a design solution that met both side's objectives."