

# Variable Incentive Pay Compensation Plans

## Guidelines & Principles

### BACKGROUND

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Under the *Public Sector Employers Act* (the Act), compensation plans, including variable incentive pay plans, must be approved by the Minister responsible for the Act prior to implementation.

It is highly recommended that public sector employers consider the following guidelines and principles when designing and implementing a variable incentive pay plan. While employers will need to design plans that are appropriate for their particular service delivery focus, they should also be consistent with industry best practices, which are described here.

The guidelines provide that:

- award payment levels should be linked to performance achievement levels, ensuring bonus payments are tied to performance measured against service or business plans/shareholder letters of expectation, and individual performance measures;
- awards should not be counted as pensionable earnings; and
- awards are only provided for superior performance, including a provision for a corporate trigger whereby awards can be withheld for inferior corporate performance.

### RECOMMENDED COMPONENTS OF INCENTIVE PLANS

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Variable incentive pay compensation plans are important instruments employers may use to *incent* superior performance from executive and senior staff. Some employers use these plans as a human resources tool to recruit and retain staff. As such, while variable incentive pay plans can play an important role in an employer's total compensation approach, such plans should reward the appropriate levels of effort, performance and results.

The following components are recommended for variable incentive pay plans:

#### Plan Governance

- Industry best practices indicate that an organization's Board of Directors should be directly accountable for development and oversight of executive variable incentive pay compensation plans on behalf of the employer and should not delegate this responsibility to staff. A Board that has put such plans in place should also be expected to have human resource/compensation committees to oversee their implementation.<sup>1</sup>

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<sup>1</sup> As a resource for all public sector employers, a best practices checklist for human resource committees of the board can be found at <http://www.gov.bc.ca/cas/publications/index.html>

- Public sector employers can develop compensation plans for their senior management and executive workforces (including variable incentive pay compensation plans). Under the provisions of the Act, any such plans must be reviewed and approved by the Minister responsible for the Act before being implemented. For the purposes of costing compensation plans, the maximum potential variable incentive pay should be used.

### **Overall Incentive Plan Principles**

- Incentive awards made under the variable incentive pay plan should be re-earnable and not guaranteed from year to year.
- Incentive awards should be designed to reward superior achievements.
- Incentive awards should be provided to reward employees for their contribution to organization's success.
- Incentive awards for a given (e.g. annual) performance period should be delivered in lump sum cash payments.
- Incentive awards should not be considered pensionable earnings.

### **Performance Measures**

- Variable incentive pay compensation plan designs should include a mix of corporate, business unit/team and individual performance measures. The relative weightings assigned to corporate, business unit/team and individual performance measures should be established with regard to the employee's ability to affect results (i.e. differences in "line of sight" for different employee groups). However, at the CEO level, the emphasis placed on corporate performance should be no less than 70%. At the VP level, the combined emphasis placed on corporate and business unit/team performance should be no less than 70%.
- Performance measures should demonstrate the delivery of clear benefits to the shareholder and must be based on the following principles:
  - Targets must demonstrate value to the shareholder with a direct link to the employers Service or Business Plan.
  - Targets should include a significant weighting (e.g. 30% to 50%) for financial performance (i.e. net income along with a range of other key financial indicators must be included).
  - Targets, other than net income, should be controllable by the employer.
  - Targets should include relative as well as absolute measures.
  - Targets should be simple and transparent (e.g. not too many targets).
  - Targets should include a mix of short-term and longer-term objectives.

## Award Levels

- Variable incentive pay compensation plans should define three levels of award:
  - i) A minimum level of achievement known as a "threshold" level. To merit this award, Service or Business Plan targets (which should incorporate a modest element of "stretch") must be achieved. There should be an 80 - 90% chance of this level being achieved.
  - ii) A superior or "stretch" level of achievement known as a "target" level. To merit this award, Service or Business Plan targets must be exceeded. There should be a 60 - 80% chance of this level being achieved.
  - iii) A vastly superior or "super stretch" level of achievement known as a "maximum" award. To merit this award, Service or Business Plan targets must be far exceeded. There should be a 10 - 20% chance of this level being achieving.
- The Target award is defined as a percentage of base salary, and the Threshold and Maximum awards defined as a percentage of the Target (e.g., Threshold of 50% of Target, Maximum of 150% of Target).
- There will be a 'trigger' mechanism whereby variable incentive payments under the plan will not be payable for any performance component for any executive if overall corporate performance does not reach a pre-determined threshold level (i.e., Service or Business Plan targets are not met). For employees below the executive level, the corporate portion of the incentive payment will not be payable if overall corporate performance does not reach the threshold level.

The diagram in Appendix "A" demonstrates the award levels described above and their relationship to performance.

## Documentation & Disclosure

- As part of good corporate practice, employers should retain documents describing and justifying payments under the variable incentive pay compensation plan. Public sector employers have the added obligation under the *Public Sector Employers Act* of reporting to the Public Sector Employers Council Secretariat any such payments made to all employees earning \$125,000 or more in base pay, and to make the plan documents and other supporting documents available to the public for viewing.
- In addition, in 2008, amendments were made to the *Public Sector Employers Act* requiring employers to disclose proactively their senior executive compensation of the CEO and next four highest ranking/paid executives of an organization earning \$125,000 or more in base pay.
- As part of these disclosure requirements, employers must identify all incentive plan performance targets and the objective identifiable measures

related to the pursuit of the performance targets. Disclose how any incentive payments made to the CEO and Named Executive Officers would relate to the performance measures and the performance targets. If targets are subjective, or are based on internal processes, the organization may describe the target without providing specific measures. Where possible, targets should be explained in terms that are identifiable as being related to publicly reported goals and achievements which would be found in annual reports or similar accountability documents.<sup>2</sup>

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<sup>2</sup> The policy can be found at [http://www.aved.gov.bc.ca/psec/documents/public\\_sector\\_reporting\\_guidelines.pdf](http://www.aved.gov.bc.ca/psec/documents/public_sector_reporting_guidelines.pdf)

# Appendix A

## Variable Incentive Pay Compensation Plans - Award & Performance Matrix -

