

# Managing Compensation and Human Capital Investment in an Uncertain Economy

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The current economic situation in the United States is being compared to the stagflation of the '70s, the deep recession of the early '80s and lately to the Great Depression of the '30s. The biggest question everyone is asking is, "How long before we will begin to recover?" Of course, this is a subjective question as everyone's definition of recovery may be different. The reality as to when the recovery will occur will vary from industry to industry, company to company and by who is doing the forecasting.

Current financial/market conditions are establishing heavy liquidity and capital challenges for many organizations throughout the country. These conditions have profoundly changed the business operating environment of most companies; with the diminishing value of company assets, borrowing power erodes. Business banks and lenders are focusing more on cash generation than income when making decisions about extending credit or investing. Highly leveraged companies may not be able to obtain credit and moderately leveraged companies are already finding financing difficult.

As companies now need to increase working capital to obtain credit and to finance continued operations, significant dollars may be permanently or temporarily "freed" from their company's total compensation program and reallocated as business investment, loan servicing or to build cash reserves.

If you assume that the recession will be long lasting or severe, you will need a comprehensive approach to managing employment decisions as well as reduction and deferred compensation strategies to ensure survival and long-term strategic success. Total compensation costs are typically among the largest line item expenses for most companies. To the extent that economic conditions have impacted your company or industry harder than others, your ability to make these employment and cost-reduction decisions may determine whether your company's survival strategies are of a long- or short-term duration. In the long term, you may face a worst-case scenario unless top management is strategic in identifying internal sources of working capital and managing their total compensation costs.

It is critical to examine both short- and long-term implications when identifying opportunities to manage employment and compensation expenses. Companies must balance the need for immediate working capital with that of a longer-term strategic and human resources perspective. Taking an extreme point of view of either perspective can have unintended consequences. The remainder of this white paper guides you through a framework to help you make these important decisions. It is organized as follows:

- Factors Driving Cost Reduction and Deferrals
- Early Reduction Strategies

- Layoffs and Workforce Reductions
- Alternative Work Arrangements
- Rethinking Your Compensation Philosophy and Programs
- The Costs of Poor Decision-Making
- Communication to Your People is Critical

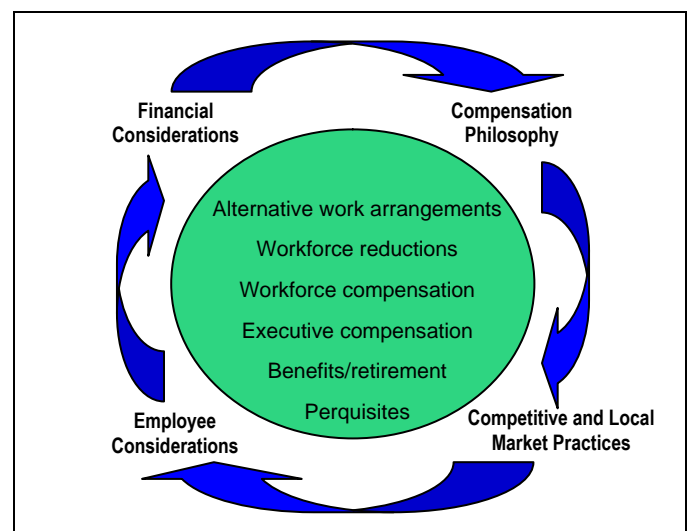
### Factors driving cost reduction and deferrals

Reducing or deferring payroll costs are a major challenge to senior management, owners and the board of directors. Quite simply, the future existence of the company may depend on it.

To help ensure your decisions will be successful, you should review the following parameters as a framework for your decisions:

- The company's current financial situation and forecasted business performance
- The company's total compensation philosophy
- Direct competitor practices and their economic situation
- Local business environment and compensation practices
- Employee considerations, in terms of the remaining employees, and the eventual need to hire new employees in the future
- Different or alternative cost-reduction strategies

The following diagram shows how these parameters affect your total compensation program and employment costs.



## Early reduction strategies

Within the early phase of a business downturn, the initial rounds of pay cuts or cost reductions are easier to implement than the later rounds. The early strategies typically include those actions that are less severe or of shorter duration, such as:

- Scaled-back salary increases, pay freezes or minor across-the-board pay cuts by level
- Deferral of variable compensation awards
- Termination for poor or marginal performance (e.g., 5-10 percent of workforce)
- Elimination or significant reduction in overtime hours

Once management goes beyond this initial level, the next phase or approach is typically more strategic and comprehensive. While these actions may be difficult, employers still need to evaluate alternatives and priorities to enable quick execution and a time-phased action plan.

## Layoffs and workforce reductions

One of the most difficult challenges is to determine the long-term implications of workforce reductions. As previously mentioned, the lowest 10, possibly, 15 percent of performers can typically be eliminated without long-range implications, especially within those companies that have not experienced a recent reduction in force or resizing. Of course, employment decisions become more difficult after the initial reduction and have more strategic ramifications. Before implementing a reduction in force, the following considerations need to be addressed:

- Employment laws, regulations, notice requirements and contracts
- Demographics of your workforce
- Succession planning
- Types of talent/skills critical to survival and ultimate success
- Replacement costs including training and on-boarding experienced new hires
- Possibility and desirability of rehiring those laid off and implications of separation arrangements
- Desire and cost of providing severance and/or outplacement
- Cost of unemployment benefits
- Alternatives to layoffs (i.e., voluntary severance and early retirement)

Business process improvement and outsourcing certain functions can also reduce costs in the short and long term and should be considered.

## Alternative work arrangements

Another option to consider when reducing compensation costs is alternative work arrangements. Companies have been using alternative work arrangements for some time to support a better work-life balance. They can also be used effectively in challenging economic times. These arrangements can include:

- Part-time, floating or flexible schedules
- Job sharing
- Converting employees to independent contractors or strategic alliance relationships
- Telecommuting
- Furloughs/sabbaticals, in some cases with benefits
- Temporary layoffs or shut downs

These strategies can be effectively utilized and should be evaluated with consideration to a position's role, exemption status and related unemployment trigger points. For example, non-core support jobs may be better suited for a contractor or alliance relationship than as key operations positions.

## Rethinking your compensation philosophy and programs

Typically, during short-term economic downturns, there are limited changes in the structure of the competitive labor market. Companies can maintain their existing compensation philosophy, particularly if there are not major changes in their business strategies. However, if the economic downturn in your industry or company is severe and projected to last several years; or if the recovery period is volatile or unpredictable, rethinking the company's compensation philosophy and strategies needs to take place. This assessment should answer the following questions:

- What permanent pay cuts do we want to make by level?
- Does the current annual incentive plan align with the business strategies for the next few years?
- At the company, division or individual level, what performance should we be driving in the next few years?
- Will we replace this reduction with increased incentives (short-term) or long-term incentives?

- What should be the mix between salary, annual incentives and long-term incentives to accomplish key issues such as:
  - Attracting, motivating and retaining key talent
  - Evaluating what is most important to the business today versus in the future
  - Determining how important it is to save cash for the company
- If a long-term incentive plan exists, should we enhance the current program to attract and retain key talent?
- If the company has no long-term incentive plan, should we consider implementing one to provide some real incentive to retain talent, especially if annual incentives may be marginal at best? If so, what type of long-term incentive program makes sense?
- What is the competition doing? What are other companies doing outside our industry but in similar situations?
- What is the local marketplace doing for its hourly workers?
- What is internally equitable when we look at the different cost-reduction strategies?
- What benefits should we take a long, hard look at? Should we reduce our 401(k) match or even eliminate it? Have we thoroughly evaluated our health care costs?
- When does it make sense to reduce these costs and what is the most internally equitable approach and yet externally competitive?

Reviewing your compensation philosophy will provide a framework for these important decisions. When you have determined an agreed upon compensation philosophy and human resource strategy, you can use them to guide you in addressing longer-term compensation alternatives, such as:

- Across-the-board salary and/or selective salary and wage reductions
- Move to more variable pay programs by shifting compensation from salaries to annual or long-term incentives
- Reduction to/elimination of retirement plans, health and welfare plans and/or employment prerequisites

All of the aforementioned actions should be considered separately and with careful thought and understanding of their

consequences. In some organizations, these considerations are preferred over major layoffs. However, in other companies, deeper layoffs are often the norm before implementing any of the above. The culture of the company, and the industry's reaction to the economic downturn, will help to dictate the most appropriate action.

It is important to realize that across-the-board direct compensation actions taken for a period of 12 to 18 months can be less dramatic if properly communicated, especially if the cuts will be restored.

### The costs of poor decision making

A company's decisions around reallocation of financial resources, especially compensation, may determine the future success, and possibly the future existence of the company. Accordingly, it is imperative that the short- and long-term implications of these important decisions be examined before they are made. Although decisions regarding workforce and/or compensation reductions can generate valuable working capital, they may also cause undesirable results that may be detrimental to the company's future success. For example, poor decisions may lead to:

- Loss of mission critical talent that could be very expensive in terms of replacement, future growth, inability to execute key strategies, etc.
- Loss of investment in training, customer relationships and intellectual capital could be very costly in the future
- Loss of talented people to competitors or to a new company who possess key knowledge, customer service relationships and industry contacts
- Poor morale with the remaining workforce may have a negative impact on performance

To maximize the positive impact on these workforce and compensation decisions, it is important to determine the potential cost of unwanted turnover, not only during the existing financial crisis, but after the turnaround in the company and/or the economy.

### Communication to your people is critical

It is extremely important to have a well thought out communications program for implementing any of the above strategies. Communicating with employees will help to:

- Minimize confusion and anxiety that is often caused by poor communication
- Ensure support and understanding of the remaining employees

- Decrease the potential de-motivational aspects of the strategies
- Properly set expectations of what may happen in the future, if appropriate
- Support the culture that top management is trying to achieve

## Conclusion

Striking a balance between financial considerations, your company's human capital philosophy and market considerations can be quite difficult when it comes to identifying cost reduction strategies. Any decisions to reduce payroll costs all have specific short- and long-term ramifications. The turnaround approach, while very effective, efficient and oftentimes necessary in the short term, needs to be balanced with a well thought out strategy/human resource perspective and methodology.

A holistic and well-executed plan can help differentiate your company and provide a competitive advantage during challenging times. The board of directors, senior management and ownership must invest the required time and effort to devise a proper and reasoned plan to safeguard the company's financial future and reputation as a fair employer.

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