Using Your 401(k) Plan as an Incentive to Improve Corporate Performance

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Section 401(k) Plans and Employee Ownership

Chapter 10

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Section 401(k) plans provide employees with the opportunity to defer a portion of their income and retain limited control over the investment of these funds. Employers often match a portion of employees' salary deferral by making cash contributions equal to a fraction of the employees' deferral. The employer match may also consist of shares of employer stock. In some cases, employees may invest a portion of their salary deferral into employer securities as one investment option within the 401(k) plan, although extensive securities disclosure requirements make this alternative less common.

Section 401(k) plan contributions typically meet a range of benefits goals, most of which are not directly related to companies' strategic performance objectives. Like all stock-based compensation, however, 401(k) plans that include employer securities can provide an important incentive for employees to improve the bottom line. This is particularly true when the incentive is combined with other necessary elements of an overall performance enhancement strategy.

The concept of linking employee incentives with shareholder interests drives recent trends toward equity-based compensation, along with attempts by many employee-owned companies to use broad-based ownership to generate performance improvements. Research demonstrates that company performance improves when employees understand the relationship between their behavior and the rewards that can accrue to them through stock ownership, and when they have the ability to use this knowledge to improve performance. However, many companies fail to recognize these potential benefits when company stock is owned through a 401(k) plan.

Share ownership in and of itself does not generate improved performance, however. Companies that want their 401(k) plan-based stock ownership to contribute to improved performance face several challenges. First, they must coordinate their ownership goals—why their 401(k) plans hold company shares—with their strategic goals. Second, they must coordinate their existing performance improvement efforts with these goals, and/or develop new strategies that enable employees to contribute to improving performance. Research by the National Center for Employee Ownership (NCEO), the U.S. Department of Labor, the U.S. General Accounting Office, and others shows that the most significant performance improvements occur when companies tie stock ownership by employees to broader efforts to encourage employees to participate at appropriate levels in company decision-making. Finally, companies must develop effective education and communication systems that clarify the links among employee behavior, company performance, and individual rewards.

While these strategies are gaining in popularity, many companies do not wish to fundamentally challenge their current business practices for the purpose of improving the efficiency of their 401(k) plan expenditures. The first task for companies with 401(k) plans that hold employer securities is to determine whether they wish to use these holdings as an incentive to improve performance. For companies that do, the second task is to design an integrated set of strategies to link employee stock ownership through the 401(k) plan to performance-enhancing behavior on the part of employees.

401(k) Plans and Overall Compensation Strategy

Compensation consists of payments to employees in return for services rendered to the employer; it takes many different forms. One important distinction is between current compensation (i.e., dollars paid now) and deferred compensation (i.e., dollars accrued and/or funded now, but not paid to the employee until some specified future point). Section 401(k) plans represent one particular form of "qualified" (i.e., tax-qualified) deferred compensation, with specific advantages and drawbacks.

Compensation costs are generally driven by market factors: they are determined not by an individual firm but by the broader labor markets in which the firm operates. Individual firms continually test the market, juggling both their total compensation and the mix of different compensation components to attract and retain the most qualified personnel without wasting resources. Companies generally pursue "compensation efficiency," which means obtaining the maximum return to the company from the total compensation paid to its employees.

One of the potential benefits of deferred compensation is its ability to drive company performance, particularly when it takes the form of securities of the company itself. Improvements in corporate performance are reflected in improvements in the value of the compensation (company stock) that employees will receive in the future, providing an incentive for employees to contribute to improving the bottom line.

In the 401(k) plan context, companies can improve the efficiency of a compensation system, i.e., generate a greater return for each compensation dollar, if the expense of maintaining and contributing to the plan leads to improved profitability. Once a company has absorbed the financial and administrative costs of setting up a 401(k) plan, it simply makes sense to try to leverage this investment to generate greater returns. Nevertheless, 401(k) plans do not conventionally include performance improvement among their core objectives.

Conventional 401(k) Plan Objectives

Companies install 401(k) plans to meet a combination of objectives. The three most common goals in establishing a 401(k) plan are:

1. ***To provide employees with the opportunity to save for retirement using tax-deferred dollars.*** Employees elect whether or not to participate in a 401(k) plan. Those who wish to defer some of their current compensation, along with the taxes that would otherwise be payable currently, can choose to do so. Those who prefer current income, net of taxes, generally need not participate. In this sense, the 401(k) alternative is a more efficient use of company compensation resources than the primary alternatives: making company contributions to a profit sharing or other deferred compensation plan on behalf of all employees across the board, only some of whom value the benefit, or making no contribution at all, thereby forfeiting the tax benefits of deferring compensation for those employees who wish to do so.
2. ***To provide employees with a limited opportunity to direct the investment of their retirement savings.*** Within a 401(k) plan, individual employees can make investment decisions that may not be appropriate or desirable for

other employees. This contrasts with other types of qualified plans, e.g., profit sharing plans, in which the company makes investment decisions that affect all employee accounts equally. (Note, however, that some profit sharing plans allow self-direction and some 401(k) plans do not allow participant direction.) This feature of 401(k) plans is similar to the flexibility in IRAs, but the level of allowable contributions to 401(k) plans is generally significantly higher. This allows companies to provide a greater level of satisfaction to employees—more flexibility than with other qualified plans and higher contributions than with IRAs—and thereby improve employees' perceptions of the value of the compensation without the company having to incur any additional expense.

3. *To increase employees' retirement benefits by matching a portion of employee contributions with company-paid (and tax-deductible) contributions.* This increase results not only from the employer match but also from any increased contributions that employees may make to take advantage of the employer match. The employer match is generally but not always made in cash. Some companies fund the matching portion with company stock, which achieves the same objective without committing additional current cash to fund the benefit. This results in some dilution, but the effect is usually minimal for larger public companies.

Section 401(k) plans have proven very popular with employees, particularly when coupled with the employer matching contribution feature. Employers are increasingly electing to fund the match with company stock, and as a result, a substantial amount of employer stock has accumulated in employees' 401(k) accounts.

A Fourth Goal: Raising Internal Capital

Some companies have added a fourth 401(k) plan objective: raising capital from employees' existing 401(k) plan account balances rather than from external sources or from after-tax direct employee investment. In this scenario, employees elect to redirect a portion of their existing 401(k) plan balances into a new company stock investment option within the plan. The company cannot control how much of his or her balance any individual may elect to redirect or, as a result, how much capital it may be able to raise in this way.

The two primary drawbacks of this strategy are that it requires significant disclosure and that it may inappropriately increase the risk of employees' retirement portfolios. First, the additional disclosure is regarded by many advisors as too complex and expensive to be generally useful, and many closely held companies are reluctant to provide employees with the detailed information that full disclosure may require.

The second drawback is that investing a significant portion of a 401(k) plan balance in employer stock may reduce the overall level of diversification in an employee's account and may inappropriately change the risk-reward profile of the portfolio. Employers may also worry that employees will not appreciate the risks of investing in employer stock and may unnecessarily jeopardize their retirement funds.

Nonetheless, closely held companies have successfully used this technique to raise capital from employees without requiring that they invest out-of-pocket monies. This can be particularly appropriate for companies that also want to provide additional incentives to retain and motivate employees.

A Fifth Goal: Corporate Performance Improvement

Independent of the various 401(k) goals discussed above, an increasing number of companies have begun using broad-based stock ownership to align shareholder and employee incentives. This mirrors an older pattern in which shareholders have provided stock incentives to a limited number of senior managers. The incentive alignment concept has been gradually extended further and further down into the organizational ranks of many firms, with the result that many large companies now have substantial stock holdings in the hands of a broad base of their employees.

The two separate goals have recently begun to converge, with the result that many companies that originally established their 401(k) plans to meet conventional benefits planning objectives are now seeking to leverage the investment that these plans represent to improve performance.

Prerequisites for Improved Performance

Performance benefits are not automatic, however, and the increase in compensation efficiency is partially offset by related financial and organizational costs. Many companies have discovered that the simple fact of ownership by itself has not generated the kinds of across-the-board performance improvements that management and shareholders might have anticipated. This experience mirrors the common experience of companies with employee stock ownership plans (ESOPs). Like 401(k) plans that hold company stock, many ESOPs have been installed with company performance as a secondary objective—the primary objectives being either to cash out a retiring/departing owner and/or to purchase an operating division from a corporate parent in order to preserve local employment.

Linking ownership to performance requires an active strategy combining various elements that together result in “ownership attitudes and behavior” on the part of employees, i.e., attitudes and behavior that focus on improving company performance. Employees tend to behave more like owners when they understand how their behavior affects the companies’ performance and how the company’s performance affects their personal rewards, i.e., the value of their company shares. These links are summarized in the Employee Ownership Performance Cycle™, illustrated in figure 10-1.

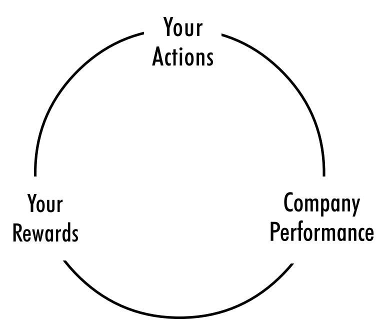

Figure 10-1. Employee Ownership Performance Cycle™

Four different tools, properly coordinated, contribute to making the links in this cycle. These tools include education, communication, participation, and incentives. The 401(k) plan itself falls into the incentive category. To contribute effectively to performance improvement, it must be coordinated with existing and/or new efforts using the other three tools. Education, communication, and participation are clearly beyond the scope of a 401(k) plan itself. However, companies seeking to leverage their plans to generate performance improvements need some form of participation mechanism to achieve this objective. Many companies already have begun various programs, e.g., TQM (total quality management), re-engineering, and related efforts, and some of these have been very successful. In many cases, these programs have not been effectively tied to education and communication efforts so that employees see the links that connect their participation to their share in the financial rewards. The sponsoring companies are therefore missing an important opportunity to leverage their investments in these programs: they may be spending organizational resources on both participation systems and on retirement plans without using each type of plan to reinforce and improve the return on the other.

Education

First, employees need to understand that a portion of their retirement benefits in the 401(k) plan are invested in employer securities, and that if company performance and the share price increase they will benefit. They need to understand what legal rights the beneficial ownership of these shares does and does not give them. Beyond technical information, companies seeking performance improvements must help employees understand how their business makes money and how each individual's behavior affects profitability.

To accomplish this, strategic 401(k) plan education should stress the three key links in the Cycle. The first link is between key performance variables—such as scrap reduction, customer returns, on-time deliveries, order accuracy, and/or other strategic quality and customer service measurements—and company performance, as measured by profitability and share value. This is often best accomplished through the development of specific product or service case studies, through which employees can see how the costs and revenues associated with a given sample product contribute to overall corporate profitability and how changes in specific measurements can affect the profitability of the case example.

The second link is between employee behavior and the performance variables, or "How I fit in." To address this task, specific examples should illustrate how changes in certain day-to-day activities can affect different key measurements. For example, if the scrap rate falls by a certain percentage, operating profit will increase by a corresponding amount, everything else being equal. Developing a clear analysis of these relationships and then developing a simple presentation accessible to employees generally requires additional effort on the part of finance and/or MIS (management information services) personnel. However, it is essential to present employees with a clear and comprehensible understanding of these critical relationships so they can focus on improving the appropriate performance variables.

The third link is between the performance variables and the individual rewards, particularly how bottom-line success affects share value. This task can be addressed by explaining the general factors that affect share value and the role that each of the key performance variables plays. This discussion can easily become quite complex, and companies must take care to present this information using simple examples that relate to employees' daily experiences.

Communication

Most companies with 401(k) plans understand that communicating the benefits of these plans is essential to achieving the three primary objectives. Common communication efforts stress an understanding of plan provisions, particularly investment options; the nature of the tradeoffs between risk and return under different investment options; cash-out terms and tax implications; and related issues.

Companies that seek to achieve the fifth 401(k) objective, performance improvement, have found that the challenge of effective communication increases dramatically. In fact, the actual communication task changes. In addition to communicating core 401(k) issues, which remains essential, companies must also provide new information regarding company performance and share value. This information should be provided on a regular basis and in various formats that are accessible to employees. Specific examples of communications vehicles may include newsletters; detailed daily, weekly and/or monthly performance reports (data-based or graphical); frequent share value updates; marketing and general strategy discussions; and many other vehicles.

Participation

Information by itself can provide employees with the understanding of why they should care about company performance. It does not, however, provide them with the means to affect performance.

In a participative management program, employees share in decisions affecting their jobs through means such as work teams, total quality management, and employee task forces. Research on corporate performance improvements in employee-owned companies consistently shows that performance improves more when ownership is combined with participation than when a company relies on either element alone. The reason is simple: without effective participation mechanisms, employees may not be able to improve company results even when they have appropriate information and incentives.

Incentives

While participation structures provide the means, they do not provide the motivation for employees to affect performance. Motivation is provided by both formal and informal incentives, including share ownership within a 401(k) plan. Many companies have a range of other performance incentives as well.

A full discussion of incentive system design issues is beyond the scope of this chapter. However, one essential principle is that various incentives must be aligned to encourage consistent behavior. Often, the most effective step that a company can take in reviewing its incentive plans is to remove and/or restructure incentives that may currently create mixed messages and encourage counterproductive employee behavior.

Getting Started and Coordinating the Steps

Once a company has determined that improving performance is a major objective of its 401(k) plan, the first step is to link the meaning of stock ownership with the company's strategic goals. This is a senior management task that should be accomplished either in the context of existing strategic planning meetings or through a separate process designed specifically for this purpose.

The next step is to determine which performance measurements each group of employees should focus on improving, and then to develop a participation plan through which employees can affect their particular measures. Companies with strong pre-existing participation programs may already have completed these steps. Those that do not have existing programs will need to commit appropriate staff resources.

The implementation of a participation program should be carefully coordinated with education strategies that clarify the links between behavior, performance, and rewards and that introduce and create employee expectations regarding the content, timing, and outcome of other ongoing efforts. Education programs represent relatively large-scale commitments (for example, company- or at least division-wide training), and should generally be timed to create momentum for the rollout of longer-term participation programs—some companies think of this in terms of "just-in-time" training.

Communication processes continue these themes and build on knowledge developed during the education/training programs once the initial efforts have been completed. Effective communication processes also provide ongoing feedback regarding successes and identify areas requiring further effort.

Finally, companies should review their compensation systems to insure that the incentive provided by their 401(k) plans is both significant enough to be meaningful to a broad base of employees and not offset by other elements of the system.

A Cautionary Note

Not every company with a 401(k) plan should necessarily attempt to link the plan to efforts to improve performance, and in these cases the education and communications tasks have a different purpose. Information should be designed to avoid the morale problems associated with employees' false expectations or misperceptions, and companies should be prepared to take active steps to clarify any inaccurate perceptions. Even in the absence of any explicitly confusing management statements, many employees may tend to make inappropriate assumptions about what their 401(k) stock ownership could mean. Management should be prepared to provide specific responses to common questions about what company stock ownership through the 401(k) plan means and does not mean, and to distribute this information appropriately so that different management personnel provide consistent answers to all employees.

There are at least two different profiles for such companies. Some companies that have other effective performance incentive mechanisms may prefer to use their 401(k) plans strictly as retirement vehicles. Employees, particularly those who are already most committed to other performance incentives, may see a link to their 401(k) plan stock ownership that the company should de-emphasize. Other employees, particularly those who may not support existing performance strategies, may choose to emphasize the fact that 401(k) plan stock ownership "has not changed anything" in an attempt to undermine the effectiveness of the other strategies. Effective communications, as described above, remain essential for the benefit of both of these groups.

Other companies may conclude that using the language of "ownership" with respect to most employees does not fit their management style. They would prefer not to raise employee questions about participation in decision-making and/or other expectations raised by telling employees that they are now shareholders. In these cases, 401(k) plans may remain entirely appropriate vehicles for employees to accumulate retirement savings, and they may also remain sensible vehicles for employers to contribute company shares as the employer matching contribution to obtain non-cash tax deductions.

However, companies that are not interested in providing vehicles for employee participation may be missing a key link in improving their performance. If employees do not believe that they can affect company performance and do not have effective mechanisms to do so, the company may not reap the fullest benefits from its existing compensation investment.

Finally, the discretionary nature of company stock ownership through a 401(k) plan is likely to result in different employees' electing to invest in significantly different amounts of company stock. This can undermine the notion that "we're all in this together." There is an underlying tension between a company's interest in using broad-based stock ownership to provide an across-the-board incentive for all employees and its interest in allowing employees flexibility in electing how and where to invest their retirement funds to increase the perceived value of this compensation.

Conclusion

Companies that have chosen to use 401(k) plans as part of their overall benefits planning strategy can improve the return on the time, financial commitment, and other organizational resources devoted to these plans. 401(k) plans that hold employer securities can be designed and presented to employees as an incentive to change their behavior in ways that improve company performance and share value and thereby increase their personal rewards. Achieving these results requires an explicit employee education and communications plan that dovetails with the company's participation systems and other incentives to create a coherent performance improvement mechanism. Companies that fail to use their 401(k) plans to achieve these additional benefits may be missing an important opportunity to improve shareholder value.

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