

Less Risk, Greater Rewards

Taking a Risk Intelligent Approach to Your Employee Rewards Program



Building enterprise value almost always requires intelligent risk-taking, whether it's taking risks to gain a competitive advantage or mitigating risk to avoid potential losses. The ability to effectively manage the risks of doing business can be the difference between a company's greatness and its demise. And one of the greatest areas of risk for an organization is employee rewards – an area where missteps can be as costly as effective management can be valuable.

It has become abundantly clear to us that designing and administering effective, efficient employee compensation and benefit programs is one of the more difficult tasks facing today's organizations. Variations in employee preferences, changing accounting rules and regulations, and increased governmental and public scrutiny are just some of the challenges facing a well-intentioned human resources (HR) function trying to design and administer the "right" employee rewards program. The game is changing at a frantic pace, and a wrong decision, or even just a delayed decision, can have a significant impact on an organization's people and its standing in the marketplace.



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While it is virtually impossible – and would be prohibitively costly – to eliminate all risk associated with employee rewards programs, it is reasonable to assume that these risks can be better understood and managed by knowing where they are likely to occur, estimating the overall potential for exposure, and determining mitigating actions. Understanding risk can help companies to not only make the right decisions but, just as importantly, make those decisions before risks turn into realized losses.

What is Risk Intelligence?

We believe that taking a *Risk Intelligent* approach to monitoring and managing employee rewards risk is vital to maintaining competitive advantage. Risk Intelligence is an approach to risk management that emphasizes the need for collaboration among risk specialists in disparate functional areas to develop a thorough, enterprise-wide understanding of risk and strategies for addressing it. At the enterprise level, a Risk Intelligent organization:

- Recognizes and manages the full spectrum of risks the enterprise faces
- Minimizes “siloes” behavior that can obscure an integrated view of risk
- Allocates proportionally more resources to more strategic and pertinent risks
- Considers effective risk management to be an organization-wide responsibility and competency
- Anticipates and prepares integrated responses to risks
- Manages risk with a view toward maximizing the upside of strategic decisions while minimizing the downside
- Acknowledges the need to take intelligent risks to create value¹

The last point is worth repeating, as it’s easy to fall into the trap of viewing risk solely as “bad outcomes to be avoided.” Rather, a Risk Intelligent approach strives to minimize *unrewarded* risks – such as the risk of regulatory noncompliance – that are associated with little or no potential for gain, while astutely managing *rewarded* risks – such as the risk of investing in a new employee wellness program – that offer the chance to realize significant business benefits in return.

The tenets of Risk Intelligence at the enterprise level apply just as well to a company’s risk management practices on a more granular level, including its efforts to manage employee rewards risks. We believe that to truly take control of these risks, a company must first adopt a Risk Intelligent approach within the functions responsible for rewards, eliminating silos in rewards risk management processes and addressing risks in order of strategic priority. Once this is accomplished, the company can then integrate its employee rewards risk management process into an overarching, enterprise-wide risk program in order to keep employee rewards risk management aligned with the organization’s larger goals.

Understanding employee rewards risks

At Deloitte, we believe that the many seemingly disparate rewards-related risks facing HR organizations can be usefully classified into three broad areas: compliance, administration, and design. Classifying risks in this way can help guide an organization’s efforts to identify patterns of risks and evaluate their potential impact on the business. Once HR and corporate risk managers understand the spectrum of risks associated with each of these areas and the relative importance of each risk to the stability of the business, they can collaboratively determine what steps to take to manage the more significant risks based on how much risk in each area the company is comfortable assuming.

Compliance

The imperative for compliance is simple: Stay out of legal and regulatory difficulties that could drain money and resources from the company as a result of fines and/or lawsuits and that could also damage the company’s reputation. Compliance activities can be expensive, and maintaining an appropriate balance between cost and risk can be one of a company’s biggest challenges. In many respects, the risk of noncompliance is a classic example of unrewarded risk, where assuming higher risk yields little or no corresponding upside in terms of business benefit.

The laws and regulations that affect employee rewards programs – ERISA, HIPAA, domestic and international tax laws, and so on – are so many and varied, and change so quickly, that most organizations understandably spend a considerable amount of effort in this area. A systematic approach based on the principles of Risk Intelligence can help an organization allocate its time and resources more effectively, improving efficiency while reducing the risk of noncompliance. The essential steps include:

- Understanding the requirements of applicable laws and regulations
- Determining the company’s risk tolerance with respect to compliance
- Identifying the processes that contribute to noncompliance risk
- Prioritizing the risks associated with each process
- Implementing and monitoring internal controls over each process according to their relative impact on business value

A Risk-based Approach

- Identify and prioritize risks
- Determine tolerance threshold for each identified risk
- Assess alternatives for mitigating the risk
- Select and implement controls to mitigate the risk
- Identify and remediate control gaps
- Monitor control effectiveness
- “Rinse and repeat” to sustain rewards governance

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Figure 2. Categorizing employee rewards risks: compliance, administration, and design



The specific internal controls to be implemented will vary from company to company depending on each organization's risk tolerance, budget, and business needs. However, some basic controls to consider include:

- Performing periodic evaluations of compliance against the U.S. Internal Revenue Code, fiduciary obligations, and laws in foreign jurisdictions
- Monitoring changes to domestic and international tax and employment law on an ongoing basis
- Proactively investigating use of the IRS's remediation programs
- Installing a compliance committee to evaluate program changes resulting from legal and regulatory issues with respect to fiduciary obligations, the U.S. Internal Revenue Code, and international legal and regulatory compliance

One main compliance challenge involves determining who is responsible. When dealing with business compliance issues, legal and a compliance office usually take responsibility for oversight, including understanding the rules of current legislation, keeping current on any changes, and providing mechanisms to train and monitor compliance. However, when it comes to regulations facing rewards programs, responsibility becomes hazy. For example, is it the responsibility of HR, Tax, Treasury, Finance, Legal, or an outside party to report rewards programs' financial information in a way compliant with U.S. Generally Accepted Accounting Principles (GAAP)? In many cases, the answer is all of the above.

The Securities and Exchange Commission's (SEC's) heightened scrutiny of equity compensation reporting and disclosures is one example of how risks associated with compliance with U.S. GAAP have increased. The SEC focuses not only on the actual accuracy of the disclosures, but also on the processes and controls the organization has in place to be reasonably confident that the information is accurate. Shortfalls in either area can raise the risk of noncompliance with U.S. GAAP. Additionally, the IRS, with its Focused Audit Approach, has also heightened its scrutiny of retirement plans. The IRS's approach focuses initially on an HR organization's internal controls to assess if the company is managing compliance risks appropriately. If it finds internal control weaknesses, the IRS will then conduct a more detailed transactional audit. The risk of incurring penalties imposed by the IRS increases significantly if a company fails to implement the proper compliance-related controls and processes.

Many organizations may feel that the complexity of shared responsibility for compliance, along with intense scrutiny from the SEC, IRS, U.S. Department of Labor (DOL), and other governmental and regulatory bodies, creates enough compliance risk exposure to warrant a thorough effort to enhance controls, improve documentation, and increase testing of controls. The advantage of a Risk Intelligent approach to such improvement is that it can help an organization prioritize its efforts according to each initiative's probable impact on the business.

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401(k) plans under the microscope

Companies that sponsor 401(k) plans are under increasing scrutiny from the U.S. DOL, which has been auditing 401(k) plans to assess the timeliness of the transmission of employee contributions to 401(k) plans as well as the allocation of fees and expenses to employee benefit plans subject to ERISA.² The DOL reports that in fiscal year 2007, it recovered nearly \$53.3 million on behalf of employee benefit plans through 1,298 civil investigations, 1,107 of them with corrected violations, and 28 criminal cases, 24 of which yielded criminal indictments.³

Lawsuits are another source of risk for companies that sponsor 401(k) plans. Some large companies, for instance, are starting to face class-action lawsuits challenging the appropriateness of fees the companies paid to investment advisors.⁴ And soon, individuals may be able to sue 401(k) plan sponsors on their own behalf. According to an August 2007 *Metropolitan Corporate Council* article:

In early June [2007], the United States Supreme Court agreed to review a case, *LaRue v. DeWolff, Boberg & Associates, Inc.*, 450 F.3d 570 (4th Cir. 2006), cert. granted, 551 U.S. ____ (2007), involving a claim that the plan administrator breached its fiduciary duty under ERISA. The question before the Supreme Court is whether a participant can bring suit in his own capacity and not on behalf of the plan as a whole and what remedy ERISA provides to an individual 401(k) plan participant who suffered a \$150,000 loss to his account due to a fiduciary breach. If the participant prevails in *LaRue*, increased litigation by individual plan participants could follow, making it wise for plan sponsors to have the ability, when necessary, to demonstrate compliance with the myriad of rules that govern plans subject to ERISA.⁵

Administration

Any business function of the size and scope of employee rewards usually requires a sprawling administrative infrastructure to support it. Generally speaking, the risks of employee rewards administration relate to efficiency and effectiveness. For example: Are the company's employee rewards administrative processes taking more time and money to run than they should? And are they effective in reaching the desired result: all the numbers add up correctly, employees are being handled appropriately, everyone receives the correct benefits, and no paperwork falls through the cracks?

In our opinion, three especially risky administrative areas are:

Global employee rewards operations – The complexity of a company's employee rewards operations increases dramatically with every new country it adds to its operating structure. Companies with employees in multiple countries must deal not only with varying immigration, labor, and tax laws, but also with the practical difficulties of administering cross-border programs, moving talent from country to country, and many other operational issues that can arise when managing people globally.

Management of employee rewards vendor relationships – The use of outside vendors to provide HR-related services adds another layer of risk to a company's employee rewards activities. In addition to compliance risks related to maintaining adequate oversight over vendors' financial reporting-related internal controls, a company also faces the possibility – as with any vendor-supplier relationship – of receiving unsatisfactory service, overpaying for service, or both, as well as the risk that administrative complexities and inefficiencies will compromise the value of the vendor relationship.

Complexities of managing employee rewards processes across multiple business units – Companies with a complex or decentralized organizational structure can incur heightened employee rewards risk simply because of the difficulty of gathering and processing information from different parts of the enterprise. Factors such as a lack of process standardization, unclear accountability for important processes and controls, and a large number of hand-offs from group to group can all contribute to errors, process breakdowns, and just plain inefficiency. The more complex the company, the more diligent HR needs to be in maintaining strong administrative controls, clearly documenting processes, and defining employee rewards responsibilities.

One area where proper administrative controls have a significant impact on an organization is equity compensation. Multiple Fortune 100 companies have been investigated for improper equity compensation practices. These investigations and scandals cause damage to the companies' reputations, cost significant amounts to pay for legal and consulting guidance, and require countless hours of internal resources to address, distracting people from performing their day-to-day responsibilities. In a majority of the cases, ineffective administrative procedures were the cause of the breakdown, not fraud or greed. And in the cases where the cause was fraud or greed, effective administrative procedures could have detected and/or prevented the action.

Another example of how breakdowns in administrative controls can significantly damage a company is the transfer of internal controls to a third party. While the responsibility for performing the control may be outside the organization, the accountability and corresponding risk still belongs to the HR function. In many cases, a company assumes that the role of the third party is clear. However, due to ineffective contracting, unclear documentation of the process, or inappropriate execution, there are countless examples of control breakdowns that have caused significant administrative errors, which have resulted in penalties, lawsuits, or payment of excess benefits.

Stock-option backdating: The fallout

The furor over stock-option backdating has tarnished more than a few corporate reputations. But reputation isn't all that's at stake. The financial consequences of wrongdoing, intentional or inadvertent, can be enormous. For example, in its fiscal 2008 second-quarter results, the semiconductor process control company KLA-Tencor announced that it agreed in principle to a \$65 million settlement with three pension entities that had sued the company for alleged stock-option fraud. Previously, KLA-Tencor had also lost about \$935 million in market capitalization after it made an announcement about the allegations in May 2006 and the *Wall Street Journal* ran an article focusing on the charges. And the company still faces five shareholder derivative lawsuits over the issue, four in California and one in Delaware.⁶

As with compliance, a crucial first step to approaching such administrative challenges in a Risk Intelligent manner is to determine and prioritize the company's business objectives with respect to rewards administration – for example, controlling cost, making it easy to move people from country to country, and/or standardizing processes and programs. Once these goals have been established, the HR organization can consider what needs to be done to fulfill them and evaluate possible mitigating actions, which could include:

- Greater automation of HR processes and technology
- Implementing or expanding an HR shared services organization
- Standardizing processes around plan administration (vesting, covenants, eligibility, funding, distributions)
- Inclusion of SAS70 and “right to audit” clauses in vendor contracts
- Establishing clear channels of communication with counterparts outside of HR who are responsible for processes and controls related to the HR process
- Strengthening controls over spreadsheet use

With a list of options in hand, HR and corporate risk managers can then better decide on how much the company wants to invest in controlling each risk and how it wants to do so. For instance, if the company places a high priority on improving efficiency and controlling cost in global rewards operations, HR might want to investigate how much of the existing inefficiency and extra cost is due to manual processes and the use of independently archived spreadsheets. It can then set up processes and controls, such as periodic cross-checking, stronger password protection, and standardized naming conventions, to curtail the sources of inefficiency – or, if the benefits outweigh the cost, choose to phase out manual processing altogether in favor of greater automation.

Design

The way employee rewards programs are designed and implemented can have a huge effect on business value, both positive and negative. Many companies are becoming increasingly concerned about their employee rewards programs' ability to help the company:

- Effectively tap today's shrinking labor pool to attract and retain key talent
- Provide satisfactory health care and retirement benefits to employees at a reasonable cost
- Meet the needs of an increasingly diverse workforce
- Demonstrate a clear return on investment on employee rewards spend
- Reward employees in a way that motivates them to act in ways that support company strategy
- Enable succession planning programs to develop future leaders

Perhaps the most obvious employee rewards design challenge relates to cost: Escalating employee rewards costs are a threat to corporate performance. In addition, pensions, medical benefits, and other programs are not only expensive in themselves, but also pose a forecasting and budgeting challenge related to changing legislation around these programs. To add even more urgency to the issue, many companies are

facing a demographically driven talent shortage that can create a pressing need to craft employee rewards programs that can help them find and keep the talent they need. An effective employee rewards program must find the right balance between employee rewards costs and risks and the value rewards can generate in terms of employee attraction, retention, engagement, and productivity.

Many companies, unfortunately, are victims of the past when it comes to employee rewards design. In many cases, decisions that made sense in a former legislative and economic environment no longer support the organization's interests. Moreover, while companies worked hard to enhance the upside potential of each individual decision, many did not factor in the impact of isolated changes on their overall rewards program or consider the potential effect of these decisions on their overall business strategy.

To design an effective employee rewards program, it is essential for the HR organization to understand both the company's overall business objectives and how its employee rewards programs are contributing to the achievement of those objectives. This involves taking a close look at what the company looks like today, what it plans to look like tomorrow, and what types of employees it will need to execute its strategies and achieve its goals – not just once but on an ongoing basis. The more concretely the HR organization can frame the company's talent needs, the easier it will be to align rewards with its overall business objectives. In addition, even though many plan design changes will focus on only one element of the overall rewards program, the impact of every change on the overall rewards program – including the potential effect on recruitment and retention as well as the cost structure – should be considered. Finally, the potential benefits of any new design should be measured against the potential risks. These include not only the compliance and administrative risks discussed above, but also the risk of wasting money on rewards programs that don't attract, retain, or engage employees.

Victims of the past

Health care costs are one of corporate America's biggest concerns in the realm of employee compensation and benefits. The problem is not only that costs are skyrocketing, but also that many companies' rewards programs designs have not evolved in tandem with the changing landscape of health care costs and corporate needs. The “stickiness” of historical benefit and retirement programs can make these programs at established organizations far more costly than they are at newer organizations. Many older companies in the U.S. auto manufacturing and airline industries, for instance, have been undercut by new entrants whose lower cost structure, thanks in part to lower health care costs, has allowed them to offer products and services to the market at a more competitive price.

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Above all, a company seeking to improve its employee rewards programs should understand the potential short- and long-term cost structures as they impact the overall financials of the company. The focus here should be identifying and evaluating the potential risks that could arise in various economic scenarios. Typically, these projections have focused on maximizing value and minimizing cost as it relates to the rewards program in isolation (or, even more specifically, the individual program being changed). We believe, however, that it is imperative for a company to view cost projections in the context of the company's overall financial operations and place more emphasis on understanding the downside risks. Doing this allows a company to better understand the enterprise-wide implications of the risk/benefit trade-offs involved in employee rewards designs.

Taking an integrated approach

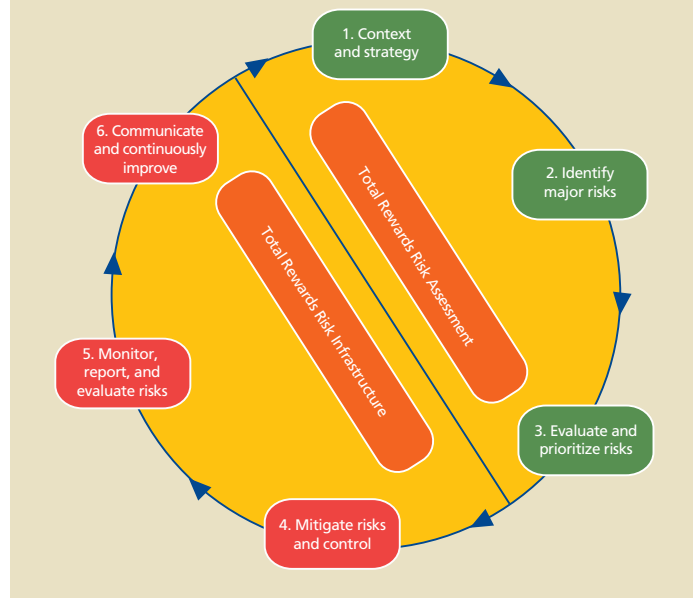
In our experience, many HR departments have a variety of processes in place to manage the kinds of risks discussed above. But we believe HR departments have much to gain by taking a more integrated approach to their risk management activities, turning what may currently be an ad hoc or loosely managed process into a formal, centrally coordinated rewards risk management program.

Figure 3 illustrates a six-step approach that we believe HR departments can take to develop a truly proactive and comprehensive approach to risk. The first three steps, in which HR conducts a "Rewards Risk Assessment," represent the active process of determining, categorizing, and prioritizing employee rewards risks. Steps 4 through 6 represent the creation of a "Rewards Risk Infrastructure" to help mitigate existing risks, implement controls to manage future employee rewards risks, establish accountability for employee rewards risks and controls, and create a governance structure to monitor risks on an ongoing basis.

Steps 1-3: Conduct an employee rewards risk assessment

Step 1: Understand the context and strategy behind the company's rewards programs. The HR organization must understand the business purpose behind the rewards programs it sponsors in order to effectively manage employee rewards risk. With a thorough understanding of the company's underlying strategy and how rewards programs support that strategy, HR can evaluate which rewards-related risks may be worth taking, which risks might be less justified, and how risks can most effectively be mitigated or avoided. HR should take it upon itself, if necessary, to recommend adjustments to the company's rewards programs that might be more effective in helping the organization reach its business goals.

Figure 3. A proactive, comprehensive employee rewards risk management approach



Step 2: Identify major risks. Risks can only be controlled effectively if one knows where and what they are. We suggest that HR compile a complete list of major risks associated with all of the company's rewards programs and activities and identify the people and departments responsible for controlling each risk. Though developing such a list may be tedious, it will provide valuable input for further steps in the risk assessment and ongoing management process.

Step 3: Evaluate and prioritize risks. A key principle of Risk Intelligence is to distinguish between rewarded and unrewarded risks: Rewarded risks may be worth taking, but unrewarded risks never are. Furthermore, both rewarded and unrewarded risks differ in their magnitude: Depending on a company's risk tolerance, some risks may be comfortably minor, others moderate, and still others unacceptably high. HR's responsibility is to understand the company's overall risk tolerance, apply the same standards to its list of rewards-related risks, and prioritize the need to mitigate each risk from most to least urgent.

Steps 4-6: Build an employee rewards risk infrastructure

Step 4: Mitigate risks and control. Here's where the owners of the risks identified in step 2 need to live up to their risk management responsibilities. Their first task should be to mitigate the most urgent risks. Then, once the immediate need is addressed, the HR organization should decide how to institutionalize those processes to mitigate risks on an ongoing basis. This could involve anything from updating HR policies and procedures to improving enabling technology to implementing additional controls and oversight over areas where risks are more likely to arise. The important thing is to treat risk mitigation and control as a process that needs to be continued into the foreseeable future – not as a simple one-time fix.

Step 5: Monitor, report, and evaluate risks. This step starts the “rinse and repeat” cycle of an ongoing risk management effort, in which the HR organization implements processes to regularly monitor risk levels and to update and re-prioritize the list of risks. Changes to internal processes, rewards programs, and general business strategy can all have implications for the risks HR manages and the way in which the department prioritizes and chooses to mitigate them.

Step 6: Communicate and continuously improve. Communication and continuous improvement are the final two components of an effective employee rewards management infrastructure. By “communication,” we mean not just the general need to build a culture that takes risk seriously, but also the need to educate the employees responsible for employee rewards processes and controls about their specific roles in the risk management process. Each employee who touches a risky process should know how to execute the correct controls, and they need to be kept up to date on any changes to those processes and controls. It’s also important to be on the alert for opportunities to implement new and improved risk-management tools and strategies as appropriate. As part of the continuous improvement process, the HR department may need to undertake a new employee rewards risk assessment (steps 1 through 3) from time to time as the business environment and the company’s situation changes.

Close collaboration among the HR department, other organizational departments, and the company’s broader risk management function is essential to seamlessly integrate HR’s risk management efforts into the company’s overall risk efforts. Because many HR processes involve other organizational functions (payroll, for example, typically crosses both the HR and finance departments), HR should work closely with process owners in those other functions to be confident that risks that arise outside of HR are being properly addressed. In addition, HR can bring considerable value to the company’s enterprise-wide risk management efforts by working with executives and the Board to help them understand the impact of employee rewards risk on the company’s employee risk profile.

The payoff

We believe that HR departments have much to gain by taking a more integrated approach to their risk management activities, turning what may currently be an ad hoc or loosely managed process into a formal, centrally coordinated HR risk management program. Human capital risks are important issues in today’s business world; they are gaining respect and interest as essential components of managing a business effectively for the long term. Anyone who has tried to run a rewards program in the recent past will know that there are significant risks involved in trying to maintain and administer an efficient and “winning” package of offerings. After a great deal of experience helping many companies apply Risk Intelligent management approaches to people and culture matters, we are more convinced than ever that including employee rewards programs under the bigger tent of enterprise-wide risk assessment and mitigation approaches is the key to simultaneously improving the upside and reducing the downside of innovative rewards programs.

A Risk Intelligent approach to employee rewards can be a tremendous asset to a company. By understanding and managing employee rewards risk, a company can achieve a competitive advantage by taking calculated risks to pursue potential gains while protecting the company’s existing assets. Using a harmonized system of people, processes, and tools to identify, prioritize, and manage risk, a Risk Intelligent approach can help guide more effective decisions on where the company should place its employee rewards investment.

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