Understanding Compensation Strategy and Pay for Performance

Red Clover

As change management consultants, part of our services focus on compensation programs that support business goals and drive results, especially for companies undergoing organizational change. Here are the key components that we look at when we design pay-for-performance compensation models.

First things first. There are rules.

Before we get into compensation strategy, there are a few behavioral rules you must understand and keep front of mind as you move forward with changes in your organization, the roles you put people in and how you pay them..

1. **Compensation influences behavior.** Every. Single. Time. If your compensation programs do not directly support the actions and behaviors that you are trying to change or reinforce, do not expect people to align. Put simply, people will do whatever it is that will put more cash in their pocket. Your best people will see the longer-term game plan and delay gratification if needed, but don't kid yourself. We're all in it for the money.

2. **Line-of-sight is critical**. If compensation influences behavior, it is critically important that your people understand the link between what they do and the impact it has on their compensation. There is nothing worse than an incentive compensation plan that people do not know how to work with. It's like burning cash in your pocket. Line of sight is the degree of correlation between the action and the result that follows. In this case, the action is work and the result is pay. What is the likelihood that extra effort will improve a specific result or outcome? If the result is improved or changed, what is the likelihood that this will be rewarded? And lastly, is the reward perceived as equitable vis a vis the effort required to obtain the result?

3. **Compensation is a negative motivator**. No other management activity is as subject to recency error as compensation - and variable pay in particular. It's always about 'what have you done for me lately.' For employers, the risk is disproportionately rewarding people who have delivered in the 3 months closest to the time when they make decisions on discretionary bonuses. For employees, on the other hand, they are predisposed to look for increased pay over time, especially variable pay. If they got a 10% bonus last year, they're looking for at least that much this year; anything less runs the risk of demotivating them and actually doing the opposite of what is intended.

4. **No one is going to care as much as you do**. If you are the owner of your company, no compensation program in the world is going to make your people care about the business outcomes as much as you do. This should not be your goal. Your goal is to create a

compensation strategy and plan that creates line-of-sight between your business objectives and the priorities and goals of your people.

5. **Get your compensation sorted out first**. Compensation is at the bottom of Maslow's hierarchy in the HR world. If you haven't sorted out your pay strategy and accurately execute the plan, do not expect to have a meaningful conversation about long-term development planning. You don't have their attention yet.

Let's look at the building blocks of pay-for-performance: Base Pay, Variable Pay, and Non-Cash Rewards.

Base pay

Base pay, whether its a fixed salary or an hourly pay rate, is the first thing that current and prospective employees will look at when evaluating whether they join or stay with your company. There is a minimum threshold of pay that you need to meet to be able to attract and retain your talent. And, as minimum wage floats to the $15 an hour level, be prepared for salary expectations to go up across the board.

So, what's the right number? Here's the thing: what you need to pay to attract and retain great people might be **lower than you think**, especially if you consider variable pay and other ways of rewarding your employees. Do not make the mistake of thinking that you have to compete on base pay alone. Look at the total mix of cash remuneration as well as the non-cash rewards that build engagement and retention.

There are several factors to consider when deciding your salary market positioning. Smaller companies tend to pay less than larger ones, partly because job complexity tends to go up with larger companies. Also, some industries have to pay more than others in order to attract good talent. Tobacco, Oil and Gas and Alcohol companies all come to mind here. You may need to pay more for specific skills that are highly sought after in the market. This is the most difficult to manage from an internal equity standpoint so consider adding other pay elements to the mix for these employees rather than simply shooting their base pay into the stratosphere. Skills requirements change over time and you may not want to pay the same premium for these skills later on.

Bottom line: Industries that are less 'desirable' and jobs that require specialty skills generally have to pay more. Smaller companies tend to pay less than larger ones.

Wage compression and internal equity

Be mindful of wage compression and the risk of pay inequity between tenured employees and new hires. If you think your people aren't talking about salary in the break room, **you're wrong**. They are. And, if they find out that the new guy is making 10% more than they are, watch out. Equity theory is essentially your employees' perceptions as to whether they are treated fairly as compared to others. If the outcome of that evaluation is positive, they will continue to deliver to expectations, if not, their input will drop to a level corresponding to what they feel is equitable. In layman's terms: they check out.

Bottom line: If your new hires are floating to the top of your salary bands, be prepared to adjust pay for your more tenured employees to account for wage compression.

Take a look at the marketplace

Glassdoor,LinkedIn, and Indeed all offer free salary data and can be a good source of information on where your market is. Be mindful, however, that these searches are all based on job title and titles have more value inside the house than outside. For example, a VP of Talent in a small company with one location is paid far differently than the VP of Talent at a multinational organization. Take a look at a few different, but related, job titles to get a more balanced comparison. Depending on your industry, you might also identify specific companies where you compete for talent and see what they're paying across a number of benchmark jobs. This is particularly relevant for sales roles and core operations functions where talent tends to move from one company to another within the same industry.

Lastly, bear in mind that these are reported salaries and will not have the same degree of accuracy as a formal salary survey. The data may be older or related to a salary range posted for an open position rather than the actual salary of a current employee. Regardless, if you see that your jobs are 30% lower or higher than the competition, you may have a problem.

Bottom line: Check different, but related, job titles to get a better feel for the market and remember that the companies you compete with for market share may not be the same as the ones you compete with for talent.

Variable pay

Variable pay is one of the best ways to link rewards to the actions that drive business change and growth. In this overview, we will be looking at several different variable pay programs: Commissions, Bonuses, Short- and Long-term Incentive Compensation, and Profit Sharing.

Commissions

Traditionally reserved for sales roles, commissions and commission-like compensation is creeping steadily into the pay mix for other job families. They are generally articulated as a % of revenue or profit that the individual or team has contributed to the business. The beauty of commission-based pay is that it is tied to the cash coming through the door and can be designed and paid in a way that is self-funding.

Keep in mind that commission plans do not always mean that you need (or want) the person to close sales. You can engage your workforce as brand ambassadors (and widen your pipeline of qualified leads) and reward them with a small commission for introductions that result in closed business. Aside from prospecting for or referring new clients, other activities or behaviors that lend themselves well to commission style rewards include repeat and increased business from existing customers, pricing changes, negotiations of more favorable contract terms, expense reductions that are linked to cost of goods sold, etc.

If non-sales employees are eligible for commissions, do not make it so high relative to the employee's total pay that it **distracts** them from their essential job functions. This involves some math but is an important step in calculating the total rewards mix to ensure that you are driving the right behaviors for a particular job role or family. As a rule of thumb, commissions generally should not exceed 20% of total pay, for roles which are outside of the sales function.

The right formula will depend on what behaviors you are trying to influence (line-of-sight) so keep in mind that your people should be able to easily understand the calculation process and there should be no surprises at payout. Consider team based over individual incentives if you want your people to work together to close deals. This tends to work well for inside sales teams. For outside salespeople and all-variable pay programs, individual incentives should make up the majority of the pay mix.

Examples

1. 10% gross profit commission on sales, less refunds. Paid to sales person
2. 3% revenue commission on sales from new customers referred in, less refunds.
3. 5% commission on achieved reduction in material wastage. Paid to project manager.
4. 2% gross profit commission on customer re-order. Paid to account manager

Bottom line: Commissions and commission-like payouts can also apply to non-sales roles. In all commission program designs be mindful of the total pay 'mix' and how much of your employees pay is at risk. Also, make sure that you're not over-emphasizing behaviors that are not part of the essential job function.

Bonuses

Bonuses are anything that is point-in-time, activity or achievement-based cash payments. They can range from small spot bonuses to reward and reinforce a specific behavior through to substantial amounts to recognize key achievements. They can be done literally at any level of the organization, for any type of employee. We've seen and done everything from gift cards to major cash rewards here.

Warning: They almost always look backward at activities that have already happened and the results that you reward do not tend to be repeated - at least not by the same person…. For example, you don't generally reward the same "Employee of the Month" over and over. So, use bonus programs to recognize the key milestones or results that you want OTHER people to follow. And, don't put too much of your total variable pay budget behind it.

Examples

1. $500 bonus for passing a professional certification exam.
2. $100 gift card for being the employee of the month
3. Incentive trips or experiences for top performers in a team
4. A free month of service to a customer for referring another customer who signs up as a subscriber. The new customer also gets a free month. (This doesn't apply to employees, but can be an effective way of mobilizing your customer base.)
5. $15,000 Chairman's award given to the employee with the most significant contribution to the business.

Incentive compensation (short- and long-term)

Incentive compensation is such a great communication tool. There's nothing quite like a well-articulated incentive program to align behaviors and motivators. Everyone can get in on it and they are so much fun! It can also be a very involved process, but here are some key points to consider:

- The more senior the role, the greater % of total pay can be made up of variable pay and specifically incentive compensation. If the person directs how work gets done in their area of responsibility, then it stands to reason the more of their pay should be 'at risk'.
- As a general rule, consider up to 5% incentive compensation for the most junior team members and up to 50% or more for senior leadership, regardless of company size. Some senior executives in large companies will have the majority of their pay 'at risk'. And, almost by definition, owners have 100% of their pay 'at risk' in the business venture.
- Keep it simple. If your people don't understand the goals, formulas or payout, then they can't adjust behaviors efficiently or effectively to hit goals. Unscrambling convoluted incentive plans can be expensive, so start off with something easy.
- Short-term incentive compensation is defined as anything with one or more payouts per year and long-term incentive compensation as longer than a year (typically 3-5 years depending on the company size and amount of the award.)
- Last but not least, you should design the plans so that, if the employee leaves the company, they forfeit the award. It is designed to motivate people and drive behavior change but can also be an effective retention tool, at least for a while.

Profit sharing

There's a lot of opportunity here as well. Everything from deferred profit sharing to straight up equity distribution. I will counsel this: if you are a private company, think twice, or three times, before setting up share grants or share options programs. Cash based, phantom or book value profit-sharing programs are generally preferred here. They allow you to retain voting rights and ownership and simplifies things in the event that you sell the business. Once you have defined what you want to achieve from a behavioral change perspective, speak to your accountant and legal counsel to help develop a program that will set you up correctly.

Like all variable pay programs, there are advantages and disadvantages to profit sharing programs. To illustrate the example, take a book value share plan. These plans simulate ownership by awarding fictitious 'shares' to employees based on eligibility (position based) and an attribution formula. The formula is based on a combination of company, organization, and team performance to determine how many 'shares' are allocated to the pool and then distributed. The shares are recorded as a journal entry but are not a charge to earnings. The value of these shares is then created through the appreciation of the business. The primary advantage of this and other equity-like programs is that it creates an ownership mentality among employees who participate. However, they also have a very long line of sight – meaning that employees can do little to individually impact the results of the pool or the award, so while they are a very effective part of the total pay 'mix', they shouldn't be used in isolation. The biggest disadvantage of book value plans is actually an advantage to employees: they can never be zero. A real share ownership program can have zero-value shares. Book value or phantom shares cannot. So there's limited downside for employees who participate in the plan.

Lastly, phantom and book value plans rarely come with voting rights. This moves the line of sight even further, but we prefer this option for private companies because it keeps key decisions in the hands of the business owner.

Bottom line: Profit sharing programs have a long line of sight, meaning that it's harder to tie individual activity to the amount of the award. They are generally reserved for senior leaders who are responsible for the long-term results of the company.

Non-cash rewards

This is where things can get really interesting, especially for small businesses. Some of these are so **meaningful** that they not only bolster talent acquisition and retention, but they can overshadow base pay. So, pay attention to what you're offering here!

Paid time off

For the time being, there is no US federal requirement to offer paid time off. Some states, including NJ where we are based, do require that ALL employers offer paid sick leave (with certain guidelines), but aside from that, you have free reign to do what you want here. Market expectations are around 2 weeks paid vacation per year, so anything in excess of this is considered attractive. Keep in mind that this has a direct cash impact in so far as you're paying people who aren't working. If you have salaried employees and somewhat seasonal work, consider bumping up vacation time with the requirement that at least some of it be taken when times are slow. There are a couple of ways to do this: either **proactively** by articulating it in your PTO policy, including blackout dates and other requirements, or **reactively** by training managers on how to approve PTO and still manage day-to-day business needs.

Other forms of paid time off include bereavement leave, educational leave and family leave. We recommend that, if you do plan to offer pay for these types of absences, that you clearly define eligibility (who and in what circumstances), duration and the pay rate. For example, we have small business clients that have chosen to offer paid family leave at 50% the rate of pay to the mother or father upon the birth of a child. You can combine vacation, sick and other paid leave as a total PTO offer. For small businesses, this is often easier to administer.

Bottom line: PTO is highly in demand for all job and salary levels. Paid sick leave is mandated in some states. If you're not already offering some form of PTO, you probably should be.

Healthcare

Group health is required for companies with 50 or more employees, but is an in-demand benefit for all employee types and something to consider regardless of your size in order to be competitive in today's talent market. Here are some high-level points that will help guide your thought process if you are an 'under 50 player' in the group health space.

- **Eligibility:** You need to have 2 employee lives covered, not including the owner and their family, in order to qualify for a group health plan.
- **PEOs:** Professional Employment Organizations are NOT the only option for small businesses to get group health. In fact, many times they are not the best option and getting out can be a costly exercise.
- **Cost:** There are some rules around employer participation in SOME forms of group health but there are options that involve little to no employer cost and still offer your employees a pre-tax benefit of group healthcare.
- **Talent:** Most candidates will ask about healthcare benefits and are generally more interested in working for companies that offer healthcare. However, they generally do NOT ask about the details of a healthcare plan during the recruiting process. Your healthcare plan does not need to be heavily subsidized to be attractive.
- **Other benefits:** There is a range of other health related benefits products on the market, often at no cost to the employer. Vision and dental are the typical examples, but there are others.

Bottom Line: If you are serious about growing and attracting top-tier talent, group health is something to seriously consider. Find a reputable benefits consultant to work with to identify your options before jumping in with a PEO. They are often not the best option.

Perquisites aka Perks

This is the fun stuff. Perks can range from company cars and phones through to gym memberships, company cafeteria or free lunch and tuition reimbursement. There are a lot of options, but do be mindful that once you add them to your rewards mix, it's difficult to take them away (remember that pesky 'negative motivator' psychology!). Also, not all perks are tax efficient, meaning that they may generate a tax liability for you or your employees. Some companies will gross up the value of a perk to offset the taxes, but it can get expensive. Talk to your tax accountant to understand what perks make sense for your business.

Here's a list of things to spark your imagination, but ask your people what they're interested in as well. They will give you the best information because it's the list of what has value to them.

Equipment: Company cars are the classic choice, but also negotiated discounts or fleet rates for personal purchase. Free or negotiated rates for PCs, Laptops and peripherals. Company phones or reimbursement for personal phone usage.

Memberships: This can range from memberships to professional associates through to private clubs, gym memberships or any member-based organization.

Education: Tuition reimbursement for continuing education or degree programs. Student loan repayment is highly desirable among millennial employees, though it is not currently tax efficient.

Travel/ Commute: Transit pass for commute costs or reimbursement for commute costs. This is standard in some locations. This can also take the form of a standard mileage reimbursement for car travel.

Employee Experience: Swag - branded apparel, desk accessories, gadgets, you name it... anything you can stick a logo on. Free or discounted lunches are also popular. Onsite fitness center with or without classes. Educational seminars on anything from meditation to retirement planning.

Bottom line: The same rule applies here as for some of the other compensation elements that we've discussed: start slow and add on as you grow.

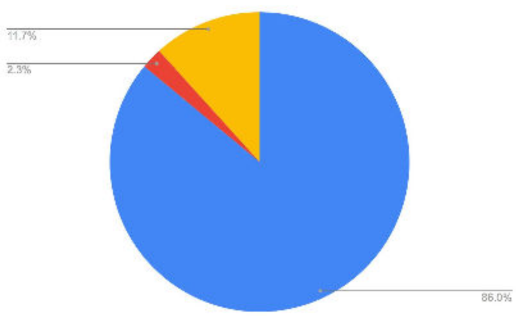
A note on legal considerations

Changing legislation and jurisprudence on **equal pay** has resulted in a more conservative approach to how we design, and critically, document pay decisions. Differences in how we pay - and differentiate between employees in cases of pay for performance - must be defensible**.** There needs to be a meaningful difference in job content, responsibility, and contribution to business results that justifies the difference in compensation or award of a bonus. Make absolutely sure that you have **job descriptions** that clearly articulate differences in responsibility from one job level to another as well as **KPI's** and other measures of success when awarding bonuses. If you're in doubt, speak with an attorney that specializes in employment law before moving forward.

Total rewards at different career stages

Generally speaking, as people move up in the organization, the percentage of their pay that is variable or 'at risk' should also go up. Consider the following example.

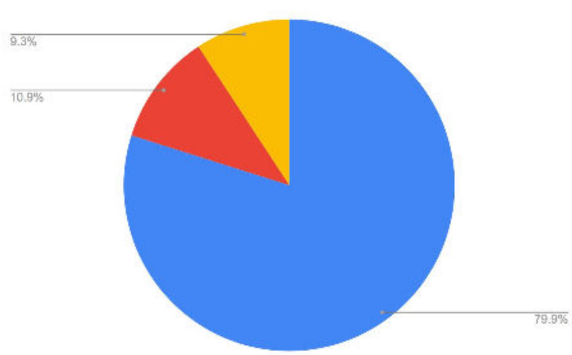
Year 1: Individual Contributor



Steven joins CoolSoftware in 2010 as an Analyst with a base salary of $60k, group health care benefits, a 401k with a 3% match and 15 days PTO. In addition, all employees are eligible for spot bonuses for candidate referrals and a certification bonus for completing a technical training course related to their work. Steven is awarded both of these in his first year and his total pay mix looks like this:

Base Pay	$60,000	87% %5 is PTO
Variable Pay ● $500 bonus for referring a successful candidate ● $1,000 for completing certification program	$1,500	2%
Benefits ● Group Health Care ● 401K with 3% match	$7,700	11%
Total Rewards	**$69,200**	**100%**

Year 3: Management

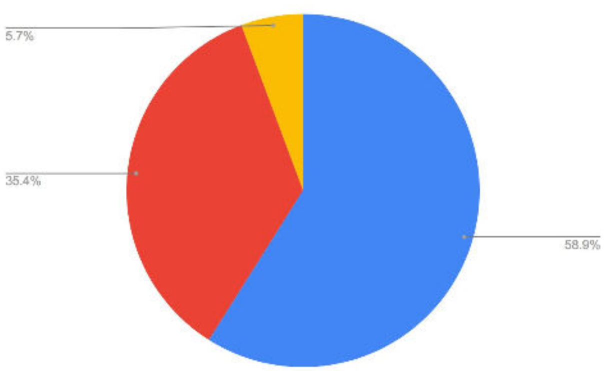


Steven continues to work for CoolSoftware. He receives a 3% merit increase in year 2 and year 3 and in his 4th year of employment, is promoted to team leader, supervising 4 analysts. As a team leader, he is now eligible for a team performance bonus targeted 10%

of his base salary, which he exceeds. His total rewards are as follows.

Base Pay	$73,320	80% %5 is PTO
Variable Pay • $500 bonus for referring a successful candidate • $10,000 for team performance	$10,000	11%
Benefits • Group Health Care • 401K with 3% match	$8,500	9%
Total Rewards	**$91,820**	**100%**

Year 8: Leadership



Steven continues to grow with CS for another 5 years and is promoted to Operations Director. His merit increases have averaged 2.5% and he received two promotional increases, one at 10% and one at 17%.

With more than 5 years of tenure, he also receives an additional week of PTO. As the Operations Director, he manages 5 teams and a total of 35 headcount. In addition to the bonuses he was eligible previously, he has a new target on his performance bonus of 20% of base pay and is eligible for a 3-year long term cash incentive targeted at 30% of his base pay. He continues to exceed performance expectations and his total rewards are as follows.

Base Pay • $60,000 • $4,200 of which is PTO	$101,660	59% %6.6 is PTO
Variable Pay • $500 bonus for referring a successful candidate • $10,000 for team performance	$61,000	35%
Benefits • Group Health Care • 401K with 3% match	$9,900	6%

Total Rewards	**$172,560**	**100%**

Over the course of his career, you can see how Steven's total rewards mix has changed. His overall compensation has grown to match his increased responsibilities. With responsibility comes accountability for results and, as such, an increasing amount of his total pay has shifted to a variable model where he is compensated based on the results that he delivers for the business.

We hope that this has helped you understand the basic components of compensation and how you design and implement and pay-for-performance model that works for your organization.

There's no time like the present. No matter where you are on your company's journey, an effective compensation program will reinforce the actions and behaviors that got you to where you are today and support the changes you need to get to the next level.

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Jen advises clients on compensation strategy and planning. She specializes in defining and implementing variable pay programs that drive desired behaviors for organizations undergoing change.

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