VARIABLE COMPENSATION

Compensation serves several purposes. In this newsletter we discuss how variable compensation can be used to change and drive employee behaviors. When well designed, variable compensation programs nurture behaviors that advance the company's strategy, improve its competitiveness, and reinforce the desired corporate culture.

The first part of the newsletter will address overarching philosophies used to guide compensation programs. Then we will discuss some common ideas that we have seen derail compensation programs. We will explain our approach and the use of tools that we have created to help develop reasonable compensation programs.

A ***SMART*** VARIABLE COMPENSATION PROGRAM

Borrowing from SMART goals and modifying those ideas to a variable compensation program, we offer the following concepts:

Strategic

The behaviors encouraged by the compensation program support a clearly articulated strategy.

While this statement may appear ridiculously straightforward, it is almost axiomatic that most companies we've seen approach compensation tactically and miss huge opportunities to motivate change and drive company performance. Start with your strategy and key strategic objectives and consider how you want these interpreted into actions and reward systems. Make sure you're your reward system drives the actions that support your strategic vision.

Measurable

The program is based upon objectives that are clear and measurable. The measurements are sufficiently sophisticated that they represent a reasonable reflection of corporate reality.

The metrics used in the program should be tracked routinely so that the board, management and employees are constantly aware of the status of the program. The program must be detailed and unambiguous enough to pro-actively ensure that there are no arguments between the board, management, and employees when it comes time for payouts against the plan.

For the programs to effectively drive performance in a wide variety of situations, metrics that reflect performance relative to competitors are strongly encouraged.

For example, if a company has a plan for 10% revenue growth and 10% EBIT, and achieves 10% growth and 11% EBIT, slightly better than plan, is this a good year?

How does this year look if the field of competitors, on average, grew 40% and averaged 25% EBIT? The company is underperforming its peer group in growth and profitability. Substantial market share has been lost. Corporate performance should be judged as poor and variable compensation at should be reduced accordingly. Using the funds of a corporation to overpay people simply because the market has taken a positive turn is a poor use of funds.

Conversely, how does the year's performance appear if competitors, on average, shrunk 10% in revenue and just achieved EBIT breakeven? Given this competitive environment, corporate performance should be judged as phenomenal, and variable compensation should be increased to reflect the strong improvement in overall corporate competitiveness.

When employees compare their company performance to that of their competitive peers and feel that their compensation program did not fairly reflect their efforts and results, it damages morale and erodes trust in future programs and in the board and managements' judgment. Figure 1 shows how a typical variable compensation program can be modified to reflect achievements relative to a competitive group.

Performance vs. Competitors				
	Above	Medium	High	Very High
	At	Low	Medium	High
	Below	Very Low	Low	Medium
		Below	At	Above
		Performance vs.Plan		

Figure 1: A qualitative pay-out matrix. A variable compensation payout is decreased in cases where the company underperforms its peers. Compensation is increased when the company outperforms the competitive sector.

The second portion of this newsletter will describe a method for implementing competitive landscape measurements.

Alignment

The compensation program reinforces the desired corporate culture and binds together the employees, management, board and investor groups.

The compensation programs for employees, the management team and the board should be similar in philosophy, reflecting the strategy and desired culture of the corporation. As an example, if your corporate culture emphasizes results, as opposed to efforts, then all plans must focus on rewarding results, not effort.

The program should be sensitive to the needs of the constituent groups: investors, employees, the board, and the management team. In the construction of the plan, various payout scenarios should be examined, with particular attention paid to the extremes of little/no payouts and large payouts. If the program is different for certain groups of people, then payout scenarios where one group is highly paid and another is not paid must be examined.

Good compensation programs require a certain level of complexity and great attention to detail. We do *not* advise constructing variable compensation programs for small groups, or individuals, as it exceedingly difficult to create a high number of thoughtful programs with consistent or meaningful structure. The net result is often a fair amount of chaos, mingled with angst and bitterness, and sprinkled with give-aways to employees.

Except for rare and specific situations, the program should not be structured such that the positive efforts of one employee result in the reduction of a bonus of a fellow worker.

Realistic

The level of performance to achieve the target payout must be qualitatively and quantitatively reasonable.

There is a clear matrix showing what payout is expected at what levels of company performance. Plans, with goals and milestones, exist so that employees know the level of performance required to achieve the payout. If employees view the program as not achievable, morale issues develop very quickly and the positive effects of the program are lost.

The level of performance has been benchmarked against the norms in the industrial sector. In other words, how does this performance compare to what is achievable in this industry. Do most companies achieve this level of performance in this industry 5%, 30%, 75%, or 90% of the time? How remarkable is this performance of the company "at-plan"?

The plan should be constructed to have some payout approximately 90% of the time, and payout at target approximately 50% of the time.

Tactical

The compensation program has to fit into ongoing programs and make sense economically for the company.

Every well-run company has tactical and operational programs in place. Examples could include reduction in product defects, improving the gross margin of the company, or marketing campaigns to introduce new products. The variable compensation program should bolster, or at least not impede, these tactical programs.

In the construction of the compensation program, the payout of the program must make sense and be affordable for all outcomes. A program that is not truly affordable is vulnerable to being changed at the end of the program when the "price tag" comes due. In a cash-constrained situation, variable compensation can be moved towards equity rewards.

SIMPLE STATEMENTS (AND THE PROBLEMS THEY CAUSE)

Many human resource professionals will begin a very beneficial and often nuanced discussion on reward systems with the executive staff and the Board, only to have the discussion disintegrate into a series of edicts coming from either the management or board members. These edicts have the effect of short-circuiting a more insightful and thoughtful analysis of possible compensation approaches. Many of these statements may sound reasonable when first articulated, but upon reflection, are flawed and harmful in practice. We will discuss some of these misconceptions and explain why they can be destructive to company performance.

"There is always a well-know solution to every human problem – neat, plausible, and wrong." H.L. Menken

No variable compensation may be paid unless the company makes money, but sales guys are exempt since they need the smell of money to work hard.

There are several issues with this approach that damage employee morale and drive destructive behavior throughout the company. First, all people, not just sales folks, can be motivated by variable compensation. The truth of the matter is that variable compensation has always been a traditional part of sales compensation, and is simply more widely accepted.

Second, although it is never desired that a company lose money, businesses do go through different stages and cycles. While losing money is never an appropriate goal, it may be inevitable given strategic objectives and the prevailing business conditions. In many situations, such as compensating teams working in early stage companies, working on major turnaround projects or supporting companies through bankruptcy, a variable compensation program is still quite appropriate. The dictum of "no loss is acceptable" is too simplistic for these scenarios.

What is much more central is the strategy of the company. If a company has a solid and credible strategy to take itself to a position of strength and sustained profitability, then it is absolutely and unequivocally appropriate to have a variable compensation program drive that strategy, whether the company is currently making money or not. Conversely, if a company has no pragmatic strategy that leads to sustained profitability, then any variable compensation program, by definition, provides rewards for essentially random behaviors.

No bonus can be given if a company is not growing.

There are legitimate reasons that a company may have shrinking revenues. For example, there could be divestitures of non-core businesses, market recessions, or the deliberate pruning of non-profitable revenue streams. It would be very appropriate to incentivize employees to advance certain strategic plans that in the short-term result in overall decreased revenues, while building competitive advantages for the long-term. Again, variable compensation is always appropriate if the company has a sound business strategy.

The Board or executive team compensates itself using a different philosophy than that used for the company's employees.

Employees are becoming increasingly savvy about board and management compensation and are very aware of disconnects between the philosophy used for board/management compensation and that used for employee compensation. For example, we know of situations where boards have granted themselves' large compensation increases while simultaneously canceling employee bonus programs after the end of the bonus periods due to financial pressures. In such situations, employees conclude that the board does not have the best interest of the company in mind with such actions.

Compensation programs have to be very simple to understand.

Compensation programs should be made as simple as possible while still incorporating mechanisms that take into account the real operational ecosystem. There are corporate, competitive, industry and market conditions to consider in the development of the compensation program. Proper attention to details will almost guarantee that every compensation program will have a certain level of complexity.

Employees *do* understand the importance of a company's position relative to its own historical performance, its competitor's, and the industry and market conditions. These concepts can be easily explained with thought and care. The result is a well-informed workforce, far better suited to deliver shareholder value.

An overly simplistic reward program will deliver results that do not support the business.

When times are tough, bonuses should be awarded for the hard work people are doing.

The purpose of variable compensation is to modify future behavior. Rewarding past actions does very little to constructively guide the direction of future work. Rewarding hard "work", i.e. working many hours or compensating people for attending meetings, as opposed to rewarding what is achieved, will result in long hours and many meetings.

Misguided compensation programs turn dysfunctional behavior into future entitlement programs.

A bonus is "a bonus" and should be given out very infrequently.

This is one interpretation of how pay outside of base compensation should be viewed. However, it is not based on how variable compensation modifies employee behaviors. Behavior modification studies show that to have an effect on behavior, the person needs to understand that behavioral efforts actually will result in increased compensation. In other words, if there is little perceived chance at a getting the prize, no real change in behavior can or should be expected.

If the intent is to avoid paying out variable compensation, it is far better to not have a program at all than to have the payout be beyond realistic reach. Forcing goals into the system that are unreachable is transparent to employees and is rightly interpreted as deception. The general guideline for a good compensation program is that a variable compensation program be "in-the-money" about 90% of the time, and pay at the target level about 50% of the time. We encourage the use of base and stretch goals to reflect the 50% and 90% targets.

As an aside, there is a significant difference in how people react to the words "bonus" and "at-risk compensation". In conversations concerning variable compensation, be cognizant that the word "bonus" is sometimes used with the intent of moving away from a behavior/reward system that is in-line with what research shows drives behavior toward a more traditional "bonus" system where payouts only occur when the company performs well in an up market.

The calculation of payout probability combines an analysis of the company's historical performance and the industry in which the company competes. The concept is simple to understand, but the model generation is relatively complex.

COMPETITIVE ANALYSIS

For public companies we advocate studying the competitive peer group during the construction of the strategic plan, annual operating plans (AOP), and compensation programs.

In the construction of the AOP, understanding in detail what the competitors have done helps in testing the AOP for "rationality". It is also a very useful to put the AOP into context for the board. In addition, the ability to place context around the AOP is very compelling when describing the AOP to employees.

For a compensation program we recommend that the competitive achievements of the company in key metrics be factored into the bonus program by the usage of a straightforward methodology.

We start this process by identifying all of the competitive public companies, including companies that may have been previously acquired. Using proprietary software, we pull all of the public 10Q and 10K documents and extract all the key financial information: the P&L, Balance Sheet, and Statements of Cash Flows. This information is then aggregated into standardized formats, which allows for a straightforward analysis on a wide variety of financial performance measurements.

During the formation of the compensation program, seamlessly incorporating this competitive positioning helps ensure that employees drive towards strategic goals and also pushes them to improve corporate performance faster than their competitors.

This relative positioning is then incorporated into a matrix model that quickly allows employees to understand what performance is required to achieve various compensation levels. Since the matrix has been developed using competitive industry information to determine relative performance probabilities, the achievement of these goals results in improving the competitive position of the company. The end result is the alignment of company goals, strategic positioning, and employee compensation.

On a closing note, public companies have to describe in great detail how compensation is justified. The work in producing a variable compensation program that is SMART, coupled with a thorough analysis of the industry peer group, provides a company with a consistent and logical framework to discuss compensation within a variety of public disclosures.

If you are interested in the mathematical tools that we have developed to analyze market sectors and compensation programs, please contact us directly.

Thank you for your continuing support of InSite. In our next newsletter, we will begin a series of newsletters discussing analytic tools, including compensation analysis, historical company and sector analysis and sector forecasting.

As always, your thoughts and comments are welcome.

Contact Information

InSite Partners, LLC
1000 Fremont Avenue, Suite 260
Los Altos, CA 94024
(650) 269-6757

http://www.InSitePartners.biz