

## “The Five Essentials of Pay for Performance”



### Overview

In adopting a rewards philosophy for how people will be remunerated for their contributions within an organization, a company has to determine what the right balance should be between short and long-term compensation and guaranteed versus variable compensation. Pivotal in that philosophy development is how and to what extent pay will be tied to specific types of performance. This issue will not be treated the same in every organization. However, every business should be able to identify certain performance objectives it wants its workforce to fulfill and the financial outcome that will be achieved if that result is attained. Such a projection can be translated into an increased shareholder value figure. With that number in mind, performance based compensation strategy seeks to answer the question, "how much of that increased value should be shared, with whom should it be shared and what form should it take?" In charting that course and carving out a Pay for Performance strategy, there are Five Essentials that you should keep in mind.

### Pay for Performance Objectives

Developing a pay for performance philosophy and strategy is easier when we understand what such an approach is intended to achieve. If effectively constructed, pay for performance compensation plans should help a company fulfill the following objectives:

- Recruit and retain the highest quality employees
- Communicate and reinforce the values, goals and objectives of the company
- Engage employees in the organization's success
- Reward contributors for successful achievements

### Line of Sight

Ultimately, the combination of rewards strategies that a company institutes should help to draw a correlation in the mind of the employees between interdependent elements:

- Vision – where is this company going?
- Strategy – how is it going to get there?

- Roles and Expectations – what role does each key person have in that strategy and what is expected of him or her in that role?
- Rewards – how will each employee be financially rewarded for the achievement of the expectations associated with his or her role

Pay for performance is the mechanism that is used to create this "line of sight" between related elements of company culture and purpose. In the final analysis, compensation needs to reinforce the behaviors that are desired within the strategy framework of the company in a way that is compelling enough to produce the desired performance. To accomplish this, there are Five Essentials.

### **Essential #1 – Must Tie Performance Awards to Shareholder Financial Objectives**

All companies have a financial responsibility to shareholders. As a result, compensation should be evaluated like any other investment by the company and within the context of the financial outcomes (return) shareholders are expecting. From this perspective, the question that should be asked when any compensation program is being considered is as follows: "does the incremental investment in this plan contribute to the company's financial success?" There are really two potential dimensions to the answer. One has to do with hard dollars – more revenues, profits, cash flow, stock value, etc. The other is terms of soft dollars – increased productivity, turnover reduction, improved client service, etc. When we treat compensation as an investment, we design plans that are paid for out of a superior return that performance engenders. In such a framework, compensation doesn't really "cost" the company anything. Rather, it's a question of determining the amount or percentage of a superior return we are willing to share (e.g. we were targeting an increase in shareholder value of \$15 million but achieved \$25 million).

### **Essential #2 – Must Employ the Proper Mix of Compensation Elements**

In our experience, the biggest compensation mistake made by growth companies is in not striking an effective balance between short-term and long-term incentives. Most often, they are more focused on the short term and either ignore or dilute rewards for extended performance. In a study VisionLink completed of 139 companies with revenues between \$250 million and \$1 billion, the following observations were made:

- Top quartile companies place a greater amount of compensation "at risk" – 66% vs. 52%
- Top quartile companies place greater emphasis on long-term awards – 42% vs. 33%

Why is this important to consider? The right blend of compensation elements is essential to drawing a relationship between three key outcomes that most growing companies are seeking to achieve:

- Increased productivity
- Meeting the "satisfaction quotient" – fulfilling both company and employee needs
- Achieving retention goals

As a result, in addition to striking a balance between short and long-term awards, companies must evaluate and allocate their compensation investment to create an effective and diversified blend of the following potential plan components: salary, bonus, long-term cash incentives, equity or phantom equity, retirement, core benefits and executive benefits. In this sense, each of these components is similar to different asset classes that are used in developing a balanced investment portfolio. Each is important in creating an overall portfolio that maximizes return while minimizing (or at least mitigating) risk. Because this evaluation is critical but not always easy, many companies seek the help of outside professionals to assist them in this effort.

### Essential #3 – Must Result in Meaningful Dollars

In considering "pay for performance" strategies, it must be kept in mind that the intent of such an approach is to modify the behavior of employees. So the question that should be asked continually is as follows: "is the carrot big enough to cause a significant change - to get and keep people excited?" The balance you are seeking is to have compensation that is meaningful and motivational to the recipient AND in line with shareholder (financial, structural and organizational) goals and expectations. Although this balance is a little different in each company, some rules of thumb might be helpful. We have found the following to be fairly typical of effective growth oriented companies:

- Short-term incentive plans
  - 40-80% of salary for top managers
  - 25-40% for 2nd tier managers
- Long-term incentives (for key contributors)
  - 40-80% of salary for top managers
  - 25-40% for 2nd tier managers

Our recommendation is that companies build financial models that project low, mid and high growth rates. They should then carve out long-term plan projections that will generate specific, identifiable dollar payouts for each of those levels. Subsequently, an assessment of individual dollar values should be made in that context - reviewing these amounts while considering shareholder return along with employee expectations and rules of thumb.

### Essential #4 – Must Embrace Performance That Employees Can Impact

This "essential" goes to the heart of what "line of sight" is all about. It is achieved when an employee can say "I can see precisely how my performance aligns with my pay!" Employees are frustrated or indifferent if they don't feel they can impact performance (and by extension, their pay). This is usually where employer frustration comes in as well. The latter feels as though his employees don't "get it" - and don't have the passion about his vision that he does. Ultimately, if employees don't feel they can actually impact the performance they are asked to achieve, there will be no return on the compensation investment for the company either. You may award me stock - but if I don't feel my role and performance can influence the stock price, then my behavior will reflect that.

## Essential #5 – Must Effectively Communicate and Reinforce Rewards

Coaching and reinforcement are the keys to creating long-term focus and commitment in the organization. In this context, compensation rewards are a means of reminding employees of what is expected – but more importantly, why it's worth it to strive for that goal. Each rewards program becomes a kind of covenant between the employer and the employee. It defines an area of stewardship, establishes expectation levels for that area and provides a conditional incentive for its fulfillment. "If you can do this, here's what it will mean to you."

Can you see then why and how each element of compensation communicates and reinforces different aspects of performance that need to be achieved? And the degree to which those performance expectations and their associated rewards are communicated and marketed will in large measure determine whether or not the desired performance is obtained. Among the tools many high performance companies use to effectively promote their rewards strategies are as follows:

- Letters and other direct, written communication
- Internet access to account values
- Modeling tools
- Personal financial planning

### In Conclusion

Like most things in business, compensation is something that requires evaluation, study, assessment, strategy, modeling and integration. Achieving a pay for performance culture does not happen without paying attention to the behaviors, activities, rewards and motivations that have to be linked and reinforced through a well engineered and effectively executed process. And if that process does not tie rewards to shareholder financial objectives, employ the proper mix of compensation elements, result in meaningful dollars, embrace performance that employees can impact and are effectively communicated and reinforced, then the results it produces will likely fall short.

VisionLink is a national compensation consulting firm focused on helping companies envision, create and sustain compensation strategies that will be key drivers of results and increase the productivity of employees.



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