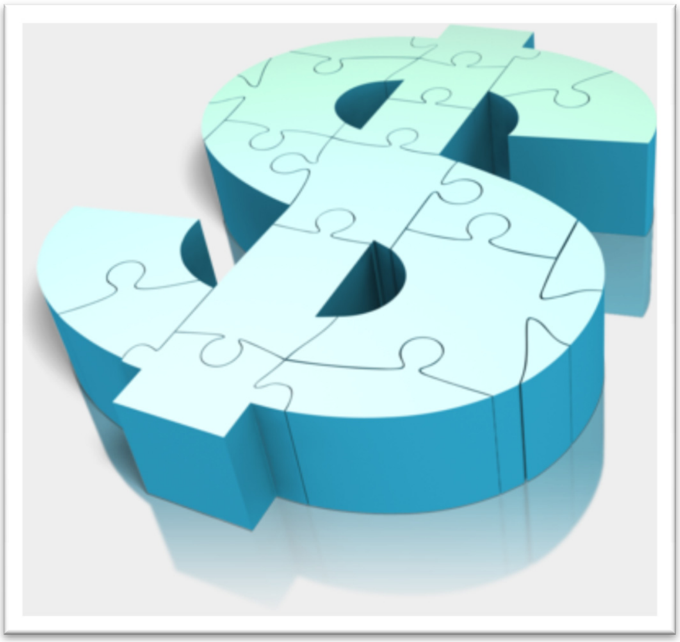
Executive White Paper

The Total Compensation Structure

Growing Your Business by Building a Balanced Approach to Rewards



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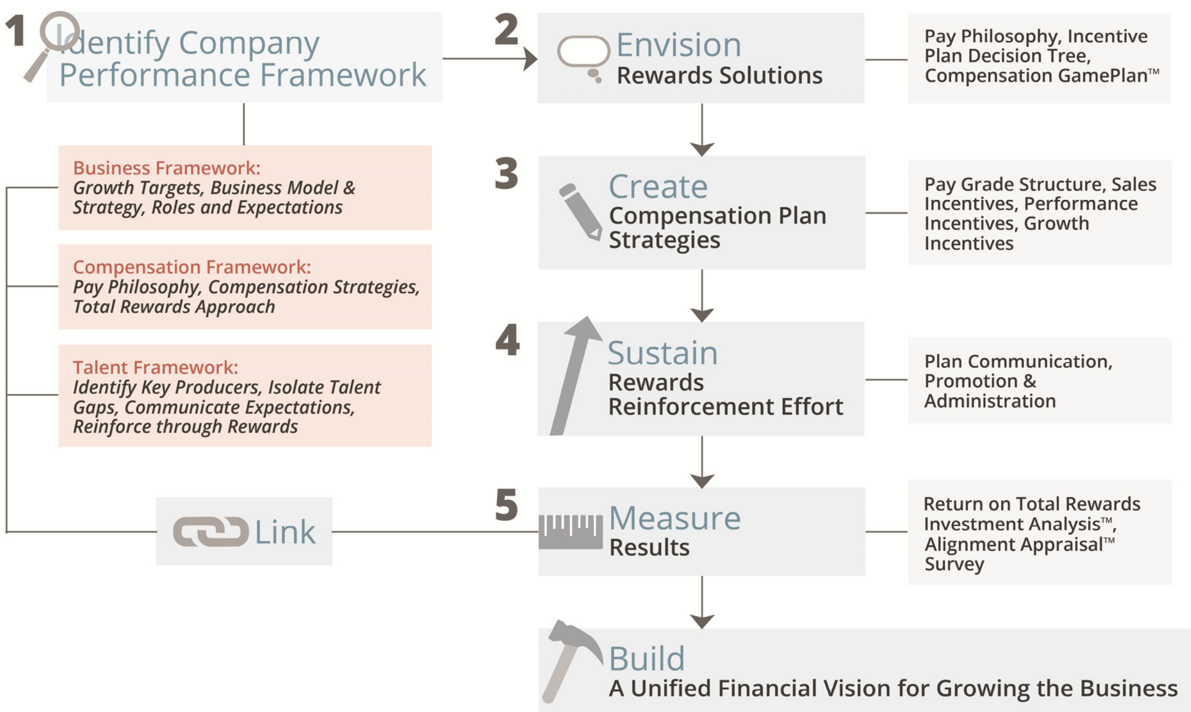
WHAT WE DO



VisionLink's focus is to enable growth-oriented companies to create greater alignment between their business plans and their rewards programs—thereby creating a unified financial vision for growing their companies. We do so by first understanding our clients' performance framework, then helping them envision, create and sustain compensation solutions that will drive growth.

Our work removes barriers to high performance stemming from an inability to recruit and retain top talent, keep employees focused on and executing key performance initiatives, or achieve an appropriate return on the shareholders' investment in their key people.

Our firm's capabilities include comprehensive diagnostic analytics, philosophy and "game plan" development, market pay studies and pay grade development, incentive plan and executive benefit design (including concept, blueprint, financial models, plan specifications, documentation and launch), and rewards administration and management.

VisionLink is a national firm headquartered in Irvine, California. Our work has helped hundreds of companies throughout the continental United States create and sustain transformational rewards strategies.

The Total Compensation Structure

Growing Your Business by Building a Balanced Approach to Rewards

By: Joe Miller

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It is the burden of almost all business leaders to determine how they will balance the allocation of their compensation investment with other financial and strategic priorities. That calculation usually manifests itself through queries such as: “Are we overpaying our employees in the IT department?” “Can we afford to hire a new sales VP?” “How can our pay programs drive better performance and less cost?” “Are we striking the right balance between guaranteed and variable pay?” When faced with such issues, those responsible for resolving them are usually left with more questions than answers. Frustration at all levels of the organization is a common result. Leadership feels powerless to affect change and employees become increasingly disenchanted. It ultimately affects and infects the entire culture.

There are, however, two basic steps that a company can follow in its approach to compensation that would resolve these issues. To more fully understand and appreciate those components, let’s introduce a hypothetical case study.

> ***Mary’s Tacos, Inc.***
>
> *Encouraged by the informal response she has received to her homemade “secret sauce,” Mary opens a taco stand in a crowded business district of Los Angeles. Lacking financial backing, she initially works the taco stand by herself. Over time, however, her tacos become increasingly popular and Mary finds herself struggling to keep up with the traffic, particularly during peak periods. So, she concludes it’s time to bring on some help. Mary hires two part-time employees and negotiates an hourly wage for their services.*
>
> *After several months of increased success, Mary sees the potential to grow her little business further. To facilitate her expansion plan, she decides to hire her first full-time employee—a taco stand manager. However, as she begins the recruiting process, she soon discovers that without a core benefits package it will be difficult to attract the right talent. So, she finds a broker to help her invest in a health insurance policy and simple retirement plan. These key additions enable Mary to attract the perfect person. With the new role filled, Mary is well on her way to growing her business.*
>
> *By offering salary and benefits, Mary is able to hire a few more employees over the course of the next year. Eventually, business proves so successful that Mary decides she wants to expand further. She secures funding to open six more taco stores in Southern California and an additional six in Arizona, Nevada, and Utah.*

Mary recognizes she will need to hire talented people to work and manage these new facilities if she wants her success to continue. She decides that she'll need an expanded pay package to compete for the best talent. She adds a new reward to her compensation offering—a profit sharing bonus plan. Mary determines she will pay out 10% of her annual profits to her entire employee population. Awards will be made at the end of every plan year based on individual performance and Mary's discretion.

The following year, Mary starts to build an executive team to help run the business: a CFO, a marketing VP, and an operations manager. She is able to attract them using her existing rewards programs but soon senses they do not share her passion and vision for growing the company. Mary realizes that a vital element in her compensation package is still missing and works with a consultant and an attorney to design a simulated equity program for her top management team. The new plan offers the executives 15% of their salary in phantom stock shares on an annual basis.

"Finally, I can start focusing on my business and stop worrying about my compensation programs," Mary tells herself.

Unfortunately, she is mistaken.

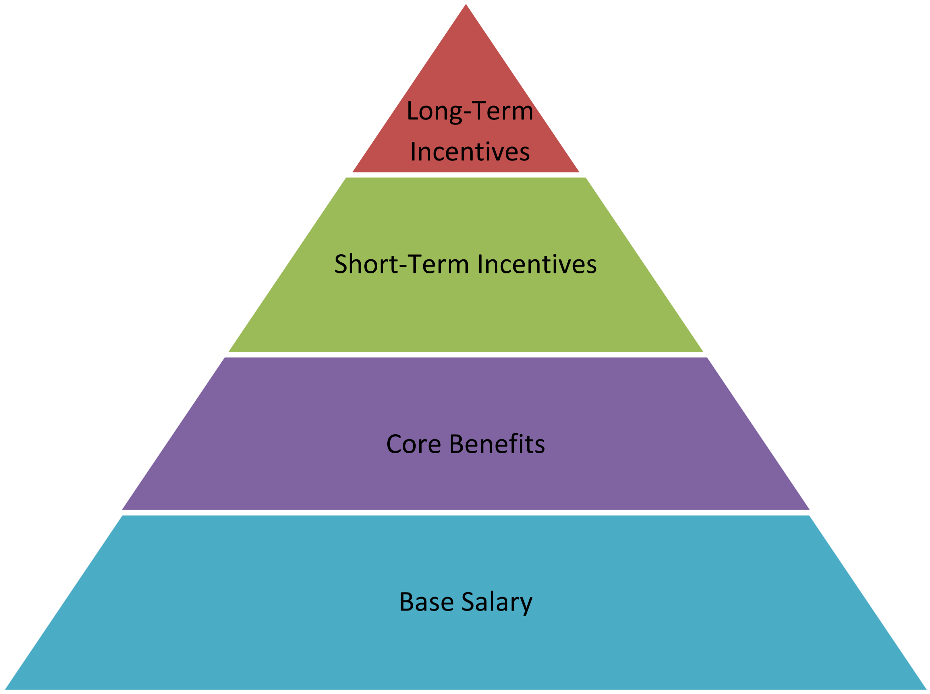
A few months after the launch of the new long-term incentive plan, a location manager approaches Mary. "I just found out about the phantom stock program and am kind of surprised I wasn't invited to participate," he says. Mary doesn't know what to say but decides to appease him by making the store manager eligible for the plan starting the following year.

A few weeks later, Mary loses her CFO to a rival taco chain when they offer him a much higher base salary. Not long after, she hears two employees discussing their bonuses. They are surprised to find out each received very different payouts. "I kind of thought we were at the same level in the company," she hears one of them say.

Mary is confused and hurt. Hasn't she built a successful rewards framework? Hasn't she addressed the critical elements of pay for her workforce—and then some? Why don't her employees appreciate the value of the compensation programs she has given them?

The Problem

In our example, Mary encountered a fundamental issue most companies experience as they fashion pay programs while moving through various growth stages. She built her rewards strategy in a piecemeal fashion by addressing compensation priorities only as each situation or employee demand arose. It could be said that Mary used a kind of "hierarchy of needs" approach where the most fundamental requirements (base salary & core benefits) were addressed first, and the more sophisticated pay elements (short and long-term incentives) were addressed last.



The rewards programs most businesses develop are engineered in this same hierarchical and piecemeal fashion. When employee demand surfaces or a key producer needs to be hired, the company reacts by installing another level of rewards.

Building compensation programs this way is certainly not illogical. In fact, it is often the most seemingly obvious way for a company to slowly build its pay plans as its growth dictates. However, building rewards strategies in this manner easily lends itself to one of the greatest pitfalls of compensation design—"siloing" the rewards development process. When a pay plan is developed in a vacuum, it becomes an island. It is created without consideration for its impact on the comprehensive compensation picture. Using this approach yields several unintended but potentially destructive consequences.

Consequence 1 - The first potential negative outcome is quite simple: *Collectively, the company's rewards programs can either over or underpay its workforce from a total compensation perspective.* In our example, Mary did not take a holistic view of compensation when she introduced new elements to her employee value proposition. She simply identified a deficit and filled it with a reward. Such an approach yielded undesirable results.

For example, consider the implementation of Mary's annual bonus plan. Recall that the taco magnate arbitrarily determined to share 10% of profits each year. Before implementing this program she should have analyzed how the introduction of this reward would impact her employees' complete compensation package. She should then have assessed how the total amount they were being paid compared with market standards. Let's examine more closely how each reward element could be impacted by Mary's new bonus plan.

> Salaries – What if Mary's employee salaries are lower than the average—say, the 45th percentile of market pay? If so, should her profit sharing percentage be higher than normal? Or…should addressing low market salaries be a more urgent priority?

<u>Core Benefits</u> – What if Mary's employee benefits are already more generous than her competition's? If so, should she offer a slightly lower profit sharing percentage to reduce cost? Maybe Mary would like to lead the market with a rich benefits package and a generous profit sharing program. If so, maybe she should increase her profit sharing percentage but keep salaries at below market pay averages.

<u>Long-Term Incentives</u> – How should the introduction of a long-term incentive (phantom stock) impact her profit sharing percentage? Should the bonus percentage be lower for employees participating in long-term value-sharing? Or…is a long-term incentive plan a non-competitive reward for her employee population at this stage of the business? Would a stronger profit sharing bonus produce better results?

This analysis should be conducted before any new plan is implemented. Before adjusting any element in a company's pay package, it behooves a business leader to perform a rewards-wide review of the entire compensation offering. It is only through that kind of analysis that those responsible for pay decisions can make certain that the introduction of any new compensation plan will contribute to a well-rounded strategy for attracting and retaining top producers, keeping them properly focused, and achieving a superior return on the company's compensation investment.

Consequence 2 - The second potential negative impact of building compensation programs in isolation can be summarized as follows: *The company may end up sending an unintended message to the workforce.* By itself, a given program might seem like a great idea; but if it is not part of a cohesive whole it won't properly frame the sense of financial partnership the company seeks to communicate to its employees. This piecemeal approach is like offering someone a dinner that includes a shrimp cocktail, a blueberry waffle, and an ice cream sundae. Although each of the foods may be delicious by itself, when combined they don't make up a nourishing or even desirable meal.

As strange as that example may be, it is, in reality, analogous to the manner in which most companies' rewards programs are developed and presented to the employee population. Consequently, many organizations aren't communicating the message they intend to with their total compensation package. They are often surprised when their workforce doesn't seem to "get it" when it comes to focusing on the standards, priorities and key performance initiatives most critical to the company. This approach to compensation development is like sending the following letter to employees and expecting a positive response in return.

> Dear Employee,
>
> Your total rewards package is a reflection of how much we value you. In case you haven't yet recognized it, we are paying you a base salary that is below market standards. However, your benefits package is at least average. That said, we can't offer any equity participation at this time or other long-term value sharing program. However, we do have a very nice bonus plan for you if the company can somehow hit its financial targets.
>
> Thanks for everything!
>
> Sincerely,
> The CEO

Here's the point. The problem for most organizations is not typically an inability to be competitive with certain rewards. Very few organization pay on the high end of the market for every pay category. (In fact there are some very successful companies that pay at the low end of the market in base salary, bonus or long-term value sharing.) The problem is that most employers introduce a given rewards plan without evaluating what their comprehensive compensation program is signaling to employees. An employee's perspective of his total pay shapes his attitudes towards the organization. Therefore, a business should have a very clear idea of what its rewards programs are communicating to its workforce, both individually and collectively.

The Solution

To avoid the unintended consequences of building rewards in a "siloed" fashion, business leaders need to focus on two commonly missed ingredients in compensation planning. First, they must clearly define a pay philosophy and second, they must develop a structure that allows them to effectively implement that philosophy.

<u>Step One – Define a Pay Philosophy</u>

A clearly articulated pay philosophy becomes a kind of "north star" to a business as it approaches compensation program development. It helps its leaders define what value creation means to the organization as well as how and with whom that value will be shared. A compensation philosophy is a unique statement about how and why the company pays its people the way it does. It forces the organization to answer certain questions. Does our company emphasize high earnings potential through value sharing (variable pay incentives) or does it prefer to pay higher than average base salaries? Do the owners of the business believe in sharing equity? If not, do they want some other kind of long-term incentive that is still tied to the value of the business? What balance does the company feel is appropriate between short and long-term value sharing? Should that be a different mix for different tiers of employees? And so on.

A company's pay philosophy also helps define the type of candidates it wants to attract to the organization. It will make it clear to those individuals how they will be rewarded for their contributions to the company's success and what is expected of them to receive those awards.

This exercise centers the priorities of those responsible for pay decisions and gives them a kind of compass to follow in developing pay strategies. It keeps the organization on course and helps leaders communicate things through compensation that are consistent with the strategic direction of the company. Without a guiding star, a ship can be lost at sea. Equally, without a clear pay philosophy, rewards program will drift aimlessly, thereby creating redundancies, unnecessary costs and dissatisfied employees.

Imagine if Mary had decided to define a pay philosophy for her organization prior to developing each new compensation plan. Perhaps she would have started with something like this:

> "Mary's Tacos, Inc. believes in providing a competitive total compensation package for our workforce. We seek to attract high performing talent that can make a contribution to the growth of the organization and contribute to the entrepreneurial spirit we want to encourage.

> As a result, we target base salaries at or a little beneath the market average while offering above-market value-sharing programs. We want every member of our team to participate financially in our success so we provide an annual reward for the value that employees contribute to our organization. The more value they create, the better the company does and the higher the value sharing payouts will be. We also believe in rewarding key producers for long-term value creation. We are committed to aligning them with the strategic direction of our business and building a sense of financial partnership with them in this way. We believe in offering core health and retirement benefits that are meaningful, though not too rich, so we can emphasize holiday and flexible time off. This reflects the company's strong commitment to work-life balance, which we consider to be the foundation of a productive workforce."

If Mary had previously defined this as her pay philosophy, the compensation scenarios she ran across could have been dealt with differently. Let's reexamine:

> *"I just found out about the phantom stock plan and am kind of surprised I wasn't invited to participate," he says.*
>
> *Mary replies, "That program has been created for executives. That is not to say that we don't value your contribution to the organization. We have tried to reward you for all the great things you have done this year with a very strong bonus payment. In the future, you may be able to participate in the long-term plan also. Here's what will need to happen for you to become eligible." (Ideally, selective plans such as phantom stock are announced only to those eligible for them, so this kind of confrontation is avoided.)*
>
> *A few days later, Mary loses her CFO to a rival restaurant company when they offer him a much higher base salary. Mary considers how to avoid this in the future.*
>
> *"Although it was hard to lose John, I think I now have a handle on the pay profile for his replacement. Our competitive advantage is our profit sharing bonus plan which I don't think John truly appreciated. In the future, I will also plan to have the person in that position participate in my phantom stock plan, but he or she will only receive the increase over the present value of the shares. My ideal candidate will have a greater appetite for variable pay."*

With the simple step of developing a pay philosophy, Mary would be able to define pay programs that reflect her key values. In addition, she would be able to address compensation issues as they arise with a clear and well defined roadmap in hand.

<u>Step Two – Develop a Pay Structure</u>

When properly designed, a pay structure is a company's rewards philosophy put into action. In our example, Mary should have created a pay structure before adding each new compensation program and then measured the impact of each plan on the composite strategy. This would have facilitated a comprehensive lateral view of all rewards programs and their alignment with the organization's rewards philosophy. A pay structure is much more than a salary structure (although a salary structure should be part of it). If a pay philosophy is the company's directional star, the comprehensive structure is its sextant for effectively guiding the organization to its rewards and desired results destination.

A pay structure can be built and customized for an organization of any size. Let's assume that the following pay structure was built based on Mary's pay philosophy for her unique organization. Rewards eligibility is classified by grade level (1-14). Each position within Mary's business would fall into one of the assigned grades. The structure defines competitive salary ranges, identifies bonus and long-term incentive targets, sets a retirement plan match percentage and establishes budgets for the health and other benefit plans.

Grade/ Band	Salary Range Min	Mid	Max	Bonus Target	LTIP Target	% Phantom Stock FV	% Phantom Stock AO	401k Match Max %	Deferred Comp Eligible	Deferred Comp Max Match	Health, Dental, Life	Vacation Days	Sick Days	Financial Planning Perk	Annual Car Allow
1	203,531	271,375	339,219	50.0%	100%	50%	50%	5%	Yes	5%	$11,141	Unlimited	Unlimited	15,000	20,000
2	150,078	200,103	250,129	35.0%	75%	50%	50%	5%	Yes	5%	$11,141	Unlimited	Unlimited	10,000	12,500
3	119,497	159,329	199,161	25.0%	50%	100%	0%	5%	Yes	5%	$11,141	25	5	5,000	8,000
4	102,632	136,843	171,054	20.0%	25%	100%	0%	5%			$6,127	25	5	5,000	
5	81,293	101,616	121,940	15.0%				5%			$6,127	25	5	5,000	
6	69,720	87,150	104,580	15.0%				5%			$6,127	15	5		
7	58,564	73,205	87,846	10.0%				5%			$6,127	15	5		
8	50,176	62,720	75,264	10.0%				5%			$6,127	15	5		
9	44,038	51,809	59,580	5.0%				5%			$6,127	15	5		
10	37,211	43,777	50,344	5.0%				5%			$6,127	10	5		
11	30,784	36,217	41,649	5.0%				5%			$6,127	10	5		
12	23,562	27,720	31,878	5.0%				5%			$6,127	10	5		
13	19,529	22,975	26,421	0.0%				5%			$6,127	10	5		
14	17,354	20,417	23,479	0.0%				5%			$6,127	10	5		

If Mary's structure was also based on credible market pay data, she would have the added advantage of being able to compare her total compensation package to that of her competitors. This would allow her to know where she is leading and where she is lagging behind. She would also feel confident that her compensation investment properly reflects her value-sharing philosophy and budget.

Because employee compensation is usually the largest investment an organization makes, a pay structure such as the one illustrated above is a necessary and valuable tool for those who must determine how that investment is allocated. It allows company leadership to easily assess the current "value" of its employee population as well as the cost of future hires. It provides a useful framework for making educated pay decisions. It frames a fair and repeatable way of determining rewards program eligibility. When shared with the general population, the structure also provides a means of illustrating how the company's pay philosophy is carried out as well as the framework for employee promotion and job family creation.

With the pay structure in mind, let's revisit the final scenario Mary experienced:

> *Not long after, she overhears two employees discussing their bonuses. They were surprised to find out they had received very different payouts. "I thought we were at the same level in the company," one says.*
>
> *Mary calls the disgruntled employee into her office for a quick conversation.*
>
> *"I wanted to let you know that I overheard you talking about your bonus payment the other day. You may not know this, but the person you were talking to is actually in another grade level and has a higher bonus target. Let me show you on this chart where he falls and where you are. I want you to know, however, how pleased I am with your performance. Should you continue to improve you will soon be a good candidate for a role with the company that makes you eligible for a higher bonus target."*

Because of a clearly defined pay structure, a challenging pay scenario is easily turned into a conversation about progression and promotion.

As long as business leaders need employees, appropriately rewarding behaviors that create value will always be a critical focus. It is important that in every organization there is an awareness of how the total compensation package is being constructed so the desired behaviors and performance are being rewarded—without creating unintended negative consequences. By determining an effective pay philosophy and establishing a compensation structure, organizations better position themselves to lay an effective foundation for all future rewards decisions.

About the Author

Joe Miller
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Joe Miller leads VisionLink's competitive salary services department. He has over 12 years' experience in compensation design and administration. He has worked in compensation leadership roles within several national organizations in addition to his direct involvement with VisionLink clients. Joe provides client companies with insight and direction relating to market pay comparisons, the development of internal pay grade structures, and linking pay decisions to performance. Joe eliminates the confusion and chaos associated with pay management.