Executive White Paper

The Most Important Compensation Plan a Company Can Have

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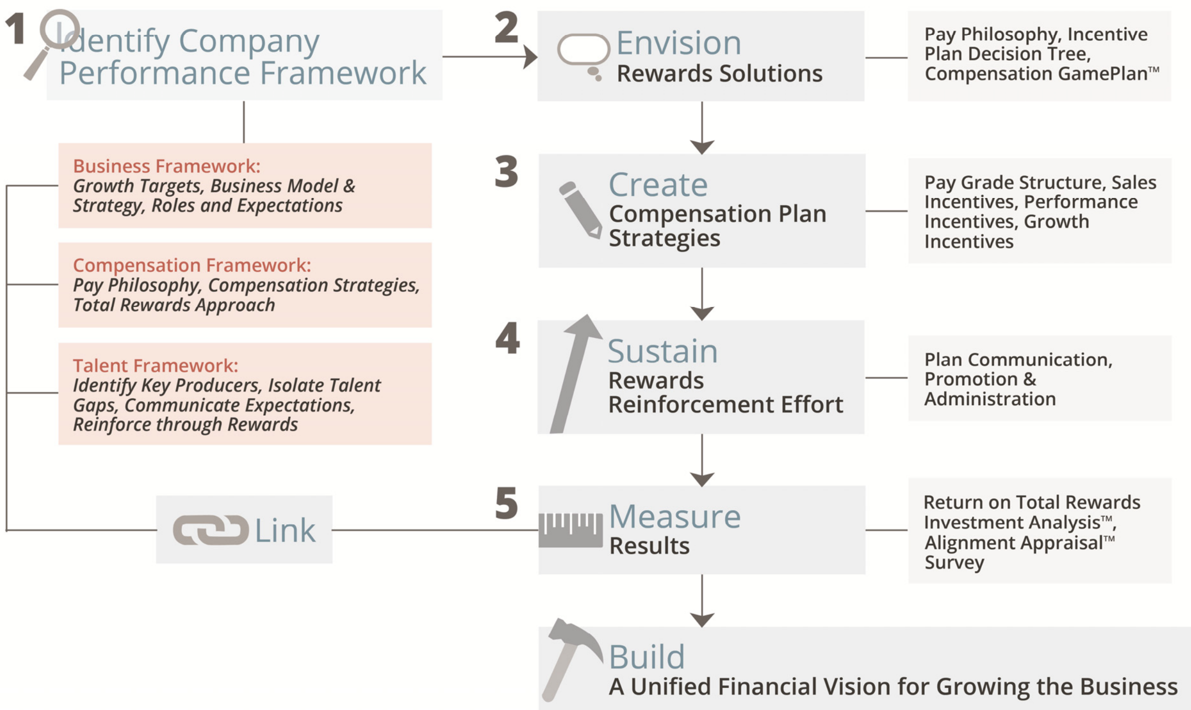

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The Most Important Compensation Plan a Company Can Have

By: Ken Gibson

February 2014

Most business leaders would love to find a single pay strategy that could become *the* answer for compensating their employees. It would be even better if it also carried a label that said something like this: "Just adopt this plan and all of your employees will perform exactly how you want them to." If it existed, it would be the Holy Grail of compensation design. Companies of all sizes would rush to implement such a plan without delay.

In the real world, everyone recognizes there is no such plan. And this paper isn't going to reveal one either, notwithstanding its title. However, knowing such a plan doesn't exist does not prevent wishful thinking on the part of those responsible for engineering and implementing rewards that will "work." As a result, this paper seeks to help those individuals find a solution to their underlying concerns about effective pay strategies.

The truth is that the most important compensation plan a company can have is going to be different for each organization. Therefore, the qualifying question that needs to be answered is: "Which pay program or strategy should get most of my attention right now?" And the answer is a definitive: "It depends." Not much help, right? Don't give up, however. The problem is solved by learning to prioritize the compensation development effort and this paper will identify how that can be done most effectively. But first, let's understand why "it depends" is a legitimate starting point for our discussion.

Framing the Issue

To begin our discussion, let's examine three sample companies that have similar yet distinct profiles for growth. In doing so, let's keep the premise of this paper in mind and ask ourselves if a single compensation program—or even combination of plans—would apply equally to each case.

Company A

Our first example is a 10 year-old technology company. It has grown from $50 to $75 million in revenue over the past three years. It wants to grow to $125 million in the next three years and believes it is capable of doing so. Right now, the company pays a salary and largely discretionary bonus to management and executive level employees. The company has been experiencing high attrition in key positions given the highly competitive talent market within the technology space. The company is privately owned by two individuals.

Company B

Our next sample enterprise is an 18 year-old transportation company. It currently produces $45 million in annual revenues and has had unstable growth recently (averaging three percent over the past five years). The business wants to grow to $75 million in the next five years. It currently pays a salary and discretionary bonus to all fulltime employees. The company has low attrition and its employees are very loyal; however, the organization has few "high performers." It is privately owned by one individual who has a son and daughter working in the business.

Company C

Our third scenario is a 20 year-old manufacturing company. It will produce $150 million in revenue this year, up from $75 million just three years ago. It plans to grow to $250 in the next three years. The organization pays salaries and three management tiers participate in a profit-based bonus pool. It has experienced modest (acceptable) attrition but several of its key producers want a greater "piece of the action" to stay. The business is privately owned by the company founder who hired a new CEO three years ago to lead the growth effort.

As we examine each of these organizations, we observe some obvious similarities: each expects to grow; all are privately held; they all offer a combination of guaranteed and variable income (salary and bonus), and; none of them has a long-term value-sharing (incentive) arrangement.

Based on those facts, some would jump to early conclusions about which compensation plan is most important to them right now. It appears obvious they should all install some kind of program that will compensate key producers for driving company growth, correct? Well, even if the answer to that question is yes (and we're not prepared yet to conclude that it is), which kind of plan should they put in? Should they all share stock? If so, with whom?

What about phantom stock? Should they give away current value or just future value? We can see that even with a number of commonalities, it is difficult to determine much about priorities and plan choices just yet. Many more issues need to be uncovered and weighed before deciding the most important compensation plan these companies could have.

With that in mind, let's examine some of the differences between these organizations. Although each is privately held, one has a hired CEO running the company, another has two owners and a third has one shareholder with two children in the business. Each has experienced difference levels of growth and is in distinct industries. Their revenue volumes differ and one organization is coming off a weak and volatile performance period. All of these differences add up to a unique profile for each of these companies. As a result, the compensation philosophy and accompanying strategy will need to reflect those distinctions.

At this point, let's pause and think about the most common approach companies take in these circumstances. Typically, they will seek out market data that will tell them what their competitors are doing. Business leaders want a pay approach that mirrors what's happening in their industry so they can remain "competitive" when it comes to the value proposition they offer potential and existing talent. However, based on the issues we have examined so far for each of the sample companies just profiled, we can see that solely mirroring what competitors are doing is not going to lead us to the right conclusions about a compensation strategy. What if your leading competitor is a public company and offers stock options? Does that mean your smaller, privately-held business should do the same? What if your company is stacked at the top with talent that has been in place for five years or more while your competitor is in rapid growth mode and is hiring a host of key producers in the next 12 to 24 months? You might need to be rewarding individuals for both past and future performance while the competing organization is interested solely in compensating for the latter. *(Note: This is not to suggest that market pay data is irrelevant or unhelpful. It has an important role. But as we'll discuss later, it's just a starting point, not the end-all in determining rewards strategies.)*

It's easy, then, to see that trying to adopt a "one size fits all" approach to compensation planning can be a bit dangerous. At a minimum, we can conclude that there aren't any silver bullet solutions. Before we can determine which compensation plan is most important for our organization, we need more information. In addition, our analysis so far reveals the need for guiding principles that can help us draw the right conclusions about compensation development priorities. But first, let's dig a little deeper with our questions so we can get a better view of the landscape that should inform our compensation strategy decisions.

The Right Questions

In setting compensation development priorities, we must know the right questions to ask. Those questions generally need to address the following issues:

1. Company Vision
2. Compensation Philosophy
3. Salary Grades and Market Competitiveness
4. Incentive Plans

Compensation planning and design decisions can't be made in a vacuum. Pay strategies need continuity and must be focused on building a unified financial vision for growing the business. Consequently, we will want to "begin with the end in mind" as we start our inquiry, as Stephen

R. Covey counseled in his best seller *The Seven Habits of Highly Effective People (Simon Schuster, Anniversary Edition, November 19, 2013)*.

Company Vision

Because compensation design is an outcome based endeavor, an organization must be able to link its rewards plans to the results it wants to achieve. Compensation can fuel, support or diminish the success of the company—and until it's helping drive growth, it needs work. Certainly, if a company has a plan to grow its revenue 30% per year over the next 36 months, or double in size in the next five years, it needs a component of compensation that communicates that priority—especially to key people that the business is relying on to help achieve that goal.

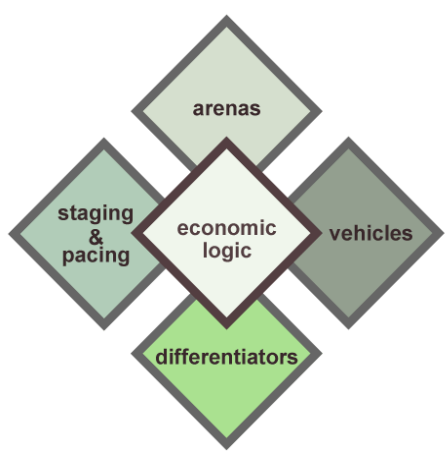
As a result, there are some key questions the company needs to be able to answer before determining which compensation strategy is most important. And there is a logical sequence to these queries as follows:

1. What has to happen in the next three years for shareholders to feel satisfied with the company's progress and growth?

   There is both a structural and a quantitative implication to that question. It is intended to make us think about the future company as though it exists today. What level of revenue is it producing? Where is that business coming from? Will acquisitions be part of the growth model? How will the company support the growth operationally? And so on.

   These issues are foundational to any plans the company makes to achieve its growth goals. The clearer the organization's vision of the future, the easier it will be to anticipate the strategies that will bring about its fulfillment—including and especially those related to compensation.

2. What is the company's business model and strategy? What has to happen with each for the company's vision and growth goals to be achieved?



A company's business model defines its revenue engine and logic. Its strategy defines how it will compete in the marketplace. Presumably, if a company is going be bigger and better tomorrow than it is today, something needs to improve with each of those. Perhaps, greater economies of scale need to be achieved. Maybe new market territories need to be penetrated. There are likely leverage points in the business model that provide the greatest growth opportunities. What are they and how can they be maximized? How should they be different in the future than they are today?

These issues will help frame a host of priorities a company has to address if growth is going to occur. As we'll see in the next questions, the answers will help determine the kind of talent decisions that need to be made—which leads, naturally, to questions regarding how those people will be recruited, retained and compensated.

3. What roles and skills are needed to make the business model and strategy succeed? Are those roles and skills presently being filled? Where are the gaps?

   Most companies think in terms of positions that need to be filled instead of determining the skill sets that will be required to make the business model and strategy excel. Roles should be associated with specific unique abilities of individuals who are capable of achieving certain results because of their distinct skills. A business needs to be able to inventory those skills and the roles it needs filled and then make an accurate assessment about its current talent relative to that requirement. It also needs to clearly communicate desired outcomes and expectations to the organization's key producers. Where there are gaps, a recruiting strategy needs to be orchestrated that focuses on attracting individuals who have the specific skill sets the company currently lacks.

4. What value proposition will best support those roles and attract the right talent?

   This question implies a couple of things. First, it suggests that there must be an approach to rewards that respects the needs of shareholders while recognizing that great talent comes to the business with certain expectations about compensation. Second, the pay approach has to align roles with how people are rewarded. A business must be able to look at compensation as a strategic tool that helps the organization become a magnet for the people it wants to attract or retain and then keep them properly focused once they are there.

Compensation Philosophy

Once a company has thought through its plans for growth, and the kind of skills and talent that will be needed to achieve success, it must define its philosophy about pay issues. This means the business has to articulate what it believes about the kind of compensation employees should receive, how much people should be paid and why. This is the role of a compensation philosophy statement. It is a written constitution that guides the development of all pay decisions in an organization. With that in mind, here are some of the questions an organization's leadership needs to be able answer in this regard if it is going to effectively set priorities regarding pay.

1. Does the company have a *written* compensation philosophy statement?
2. Does that statement clearly articulate how the business defines value creation?
3. Does it clearly communicate the kind of performance the company is willing to "pay for" and how it plans to share value?
4. Does the philosophy statement define where the company wants to be relative to market pay for both salaries and total compensation?
5. Does it establish the balance the company wishes to achieve between guaranteed and incentive pay?
6. Does it likewise define the balance the organization deems appropriate between short-term and long-term incentives (value-sharing)?

These queries help a company think about compensation as a means of creating alignment between the company's vision, its business model and strategy and how it thinks its people should be rewarded for their contributions to each. When a company builds an effective compensation philosophy statement all other decisions about pay suddenly become much easier. It also enables the company to paint a clear picture for current and potential talent not only about how it will be paid, but the reasoning behind the organization's compensation approach. It becomes a kind of filtering process for finding the best people. If someone doesn't relate to the organization's pay philosophy, it tells you something about his desire and ability to align his performance with the results the company seeks.

Among the things a philosophy statement might include are the following:

- We believe company shareholders should receive a return on their capital investment (e.g. 12%) before value is shared with other members of the organization.
- Beyond that return on capital, we believe value should be shared with those who help create it.
- We believe value sharing should be split 50/50 between rewarding short-term and long-term performance.
- We believe in being at the 45-50th percentile for salaries but in providing high upside earnings opportunities through value sharing.
- For key positions in the organization (identify), we believe in being at the 90^{th} to 95^{th} percentile in total compensation and offering unlimited upside earnings potential.

The key to an effective philosophy statement is that it truly reflects what the organization believes about pay. It can't be just words to which leadership offers lip service as many do with their company's mission statement. It should ultimately guide how compensation is explained to employees and provide the rationale behind rewards plans that are introduced. If there is a discrepancy between the philosophy and how people are actually paid, the workforce will know it and the company will lose credibility. Conversely, if there is harmony between the organization's business plan, its compensation philosophy, the roles and expectations of its people and how its talent gets paid, a sense of fairness is felt and trust and confidence soars. A culture of confidence leads to self-perpetuating cycles of success.

Salary Grades and Market Competitiveness

Many company leaders whose businesses have experienced growth over a period of time wake up one morning and discover there is no real rhyme or reason to how they structured salaries and other basic components of pay. They have made their best effort over the years to set up plans that will help them attract the talent they needed in the moment. However, sooner or later they come to the realization that there needs to be a well thought-out system to how salaries will be set and what the overall pay structure should look like.

To know how big a priority this should be "right now" for a given business, a company should consider its answer these questions:

- Have you established clear pay grades and defined job "families?"
- Are you satisfied your organization is competitive with market pay standards for the most critical positions in your company?
- Are your salary levels consistent with your compensation philosophy?
- Have you set up a total compensation structure that shows the rewards and benefits eligibility level for each position "grade?"
- Do you have a system for making compensation decisions and a designated team or committee that reviews rewards plans and issues?

There are more questions that could be asked, but you get the idea. Not much progress can be made in determining the potential merits of a given compensation strategy until a framework and context has been created. Otherwise, the organization either ends up putting the cart before the horse (it tries to develop a long-term incentive plan when it doesn't even have salary grades set up up) or creates a pay plan in a vacuum without consideration for its impact on the rest of the rewards structure.

<u>Evaluating Salaries and Market Pay Data</u>

Many organizations struggle with the right way to approach a market pay assessment and the accompanying establishment of company-wide salary levels. They know data is available but either don't know how to use it or they expect the data they gather to virtually make decisions about pay for them. In either case, an effective process is needed to ensure that an outcome is achieved which properly reflects the company's philosophy statement and establishes a structure for compensation evaluation and decision-making going forward.

Any approach to the evaluation of market pay data must be done through the prism of four components: industry, geography, experience and capabilities. In other words, every position's data point is going to be influenced or tempered by one or all four of those elements. However, using those categories as filters is not the end point of an assessment. It is just the beginning.

Data sources use various criteria and methodology for cataloging their findings. As a result, it is usually wise to obtain data from three to five different providers and then average the results. That will give you a fairly good idea of what the market says about how most people are paid for a given position. This will be most accurate for larger companies in well-defined industries and harder for smaller organizations in more niche markets, for obvious reasons.

Once the data has been secured and averages computed, the real work begins. The market pay analysis should then go through the following steps:

1. **Set Standards.** A company needs to determine where it wants to be relative to market pay. This needs to be part of its pay philosophy. For example, a company may choose to be at the 45-50th percentile of market pay, but have high upside earnings potential available through value sharing (short and long-term incentives).
2. **Match Positions.** With a philosophy in place and the data obtained, a company has to line up that data as best it can with the positions being evaluated. Some positions will align with the data better than others and the company will need to identify those that seem to be anomalies.
3. **Assess Preliminary Findings.** Upon comparing the data with the positions being reviewed, a company will need to make some initial assessments. Are there large discrepancies with some positions? What might account for that? Does the data not seem to apply to some positions? If so, is there another position that has similar duties that can be used as a basis of comparison? And so on.
4. **Make Initial Adjustments.** With the evaluation just performed, an organization is in a position to make some "first pass" judgments about where pay should be for certain positions. Others may have some level of uncertainty attached to them. Where the information is reliable enough, the process of defining salaries or ranges can begin.
5. **Assess Variances.** Now that salaries or ranges for some positions are determined and others are still undetermined, an evaluation of discrepancies has to be made. Is more data needed or available? Is the company in a position to "defend" the pay grade assignments it has made? Are the salary levels consistent with the pay philosophy?

6. **Adjust for Internal Equity.** Regardless of what market data indicates, some positions may have more significance within one company than they do in another. That relative importance has to be taken into account in making final determinations about pay. Also, such positions become a kind of benchmark against which other roles are evaluated and compared. The company makes a determination where certain positions should be “relative to” the benchmark. Adjustments in pay levels are made accordingly. This is what it means to adjust for internal equity issues.

Building a Total Compensation Structure

When properly designed, a pay structure becomes a company’s rewards philosophy put into action. In an ideal rewards construct, a total compensation framework should be developed before adding any new program. As plans are developed, they are measured against their impact on the composite strategy. A total compensation structure gives company leadership 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 “North Star,” the comprehensive structure is its sextant for effectively guiding the organization to the desired rewards and 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 a sample company’s pay philosophy for its unique organization. Rewards eligibility is classified by grade level (1-14). Each position within the 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 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 the structure is also based on credible market pay data, the organization would have the added advantage of being able to compare its total compensation package to that of its competitors. This would allow a compensation committee to know where it is leading the competition and where it is lagging behind. It would also feel confident that its compensation investment properly reflects its value-sharing philosophy and budget.

Because employee compensation is usually the largest deployment of financial capital most organizations consistently make, 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 offers a fair and repeatable means 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.

Ultimately, a total compensation structure makes it easier to determine which pay program is the most important to address “right now” for a given tier or group of employees. Until one is constructed, *it* is probably the most important pay element to address.

Incentive Plans

Defining the role of an incentive plan in a compensation structure is critical and often misunderstood by those responsible for designing pay plans. As a result, many companies either misuse incentives or abandon them altogether thinking they have no real impact on performance. If that’s the case, it probably needs to become a priority to assess what kind of incentives will be most effective and how they should be constructed.

As it relates to incentives, these are a few of the key questions an organization needs to be asking:

1. How does the company tie pay to the results and outcomes for which individuals are responsible?
2. How does the organization balance the need for employees to focus on both short and long-term results?
3. What pay mechanism exists that allows employees to participate in the value they help create?
4. How does the company frame the financial partnership it has with its key people?
5. What metrics and measures are used to define the earnings potential for key producers in the organization?

Much of the literature on this subject in recent years simplifies the issue and suggests incentive plans don’t really “work.” If the argument is that incentives can’t really change behavior, then there’s no real argument here. However, that isn’t the role of an incentive and it misses the point. Companies need to be able to define what it means to create value in the business and then institute a mechanism for sharing it with those who made it happen. When incentives are transformed into “value sharing plans,” they take on a different meaning and have a greater impact.

Compensation in general—and incentives specifically—are a way of framing the financial partnership a company has with its employees. If you do away with value sharing, you fundamentally alter the nature of the relationship between key producers and the organization. The best talent wants to know that if it helps create value, there's a means of benefiting from it. In that context, the test of an incentive plan's effectiveness is whether it creates alignment and effectively defines the financial relationship the business has with a given employee. If value sharing is done "right" it aligns the way people are paid with the growth objectives for which those individuals are responsible.

Some organizations write off incentive plans because they've tried paying an annual bonus in the past and found its impact lacking. This may have occurred because it was a poorly designed plan or wasn't the kind of value sharing that was needed at the time. A company must be able to determine which type of incentive will best focus its people on the objectives most critical to be achieved currently and therefore should be given the highest priority. Sales incentives, for example, should give shape to individual roles on a business development team and define how each part of the sales process should be rewarded. Sometimes this needs to be the focus "right now." If so, an organization needs to look carefully at whether the strategy it is using properly supports the outcomes being sought.

Performance incentives, on the other hand, are typically more broad-based and should create focus on the revenue engine of the company. They are intended to emphasize what needs to happen "this year" to ensure the business model is succeeding. Alternatively, growth incentives share value that is created over an extended period of time—typically three years or more. They, then, are employed with a company that is in growth mode and needs key people to balance their attention on both short and long-term results and outcomes.

If an organization wants to attract and retain premier talent, it must have a wealth creation mechanism that will be motivating to key producers. This argues for the development of a long-term value sharing plan that allows those who drive growth to participate in it financially. Many organizations shy away from implementing a long-term plan because they assume it means they will need to share stock. Not so. Ultimately, there are about nine different kinds of long-term value sharing arrangements a company can employ. What a company needs is a process to evaluate which is right for its organization. Here is a list of some alternatives.

1. Stock Options
2. Performance Shares
3. Restricted Stock
4. Phantom Stock Options
5. Performance Phantom Stock
6. Phantom Stock

7. Strategic Deferred Compensation
8. Performance Unit Plan
9. Profit Pool

Each of those plans has its own variations and nuances. A tool that can help an organization determine which plan is right for its company can be found at: http://phantomstockonline.com/tools/which-plan-is-right-for-your-company.aspx.

Ultimately, most companies will need all three kinds of incentives (sales, performance and growth) to build a value proposition that will attract and retain the best talent. Each is a strategic tool to help communicate "what's important" and the outcomes the company, department or individual should be focused on achieving. All play a critical role in creating a unified financial vision for growing the business, which should be the defining role of compensation in any organization.

Planning Phases

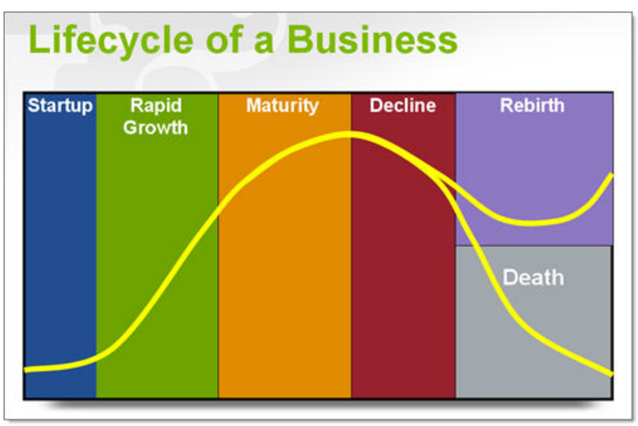
As we look at the profiles of the companies talked about at the beginning of this paper, and consider their situations relative to the questions just covered, we can see that determining which compensation program is most important to a company "right now" really depends on a range of issues. The businesses described have similarities but also many distinctions that make the development of an effective rewards strategy nuanced and situation specific.

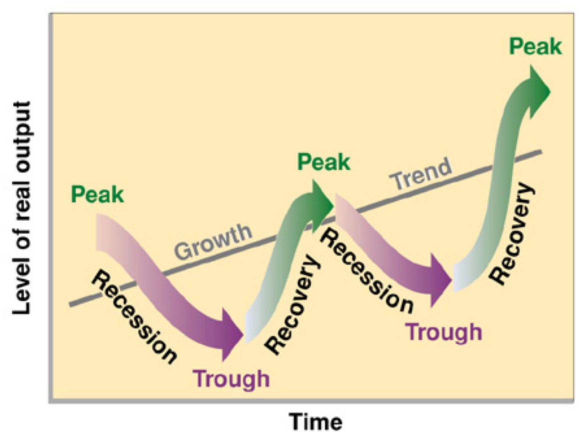
Before trying to determine which specific plans might be most important, an organization would be better served by using planning phases in which rewards strategies can be considered and given context. Below is an illustration of how these phases might be sequenced.

Note how these phases have a logic and order to them.

- Before any pay program can be considered, the company must have a clear picture of where it's headed and what it believes, philosophically, about how people should be paid and value should be shared.
- Before constructing sales and performance incentives, pay grades need to be established and a compensation structure framed. Without those, the company runs the risk of creating new programs in a vacuum, without consideration for their impact on a comprehensive pay strategy.
- Once the total rewards picture is complete, the organization is in a position to envision how it needs to reinforce the financial partnership it wants to have with its workforce and implement a strategy for managing and communicating each specific plan over the long term.

So what determines which phase of planning a company should be addressing "right now?" And does an organization ever reach a point when it's "done" with this process? Well, the answer to the latter question is "not really." That is because businesses go through cycles, and where they are in that evolution largely determines which phase needs attention again (which also answers the first question). In general terms there are two dynamic progressions, as illustrated below, that impact compensation planning: the business evolution cycle and the business economic cycle.





These cycles are dynamic, not static. As a result, the phase of compensation planning that is required for each is likewise going to be fluid. For example, as a business moves through the startup and into the rapid growth stage, it might need to pause and rethink how it has organized its salary structure. It will want to determine whether the pay levels it originally established for given positions are still relevant and market competitive. As this same company enters a period of economic distress—due to either internal or external factors—it may need to focus on how its incentive plans are structured. For example, during such periods, the organization may want to place more emphasis on long-term value-sharing arrangements (which don't have a cash flow impact on the business right now) that offer significant upside potential for key producers "down the road."

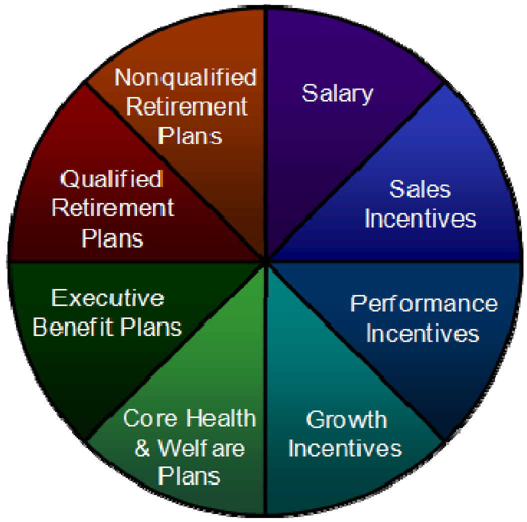
In short, the pay factors to be considered at any point in time are numerous and they change regularly. A company needs a system such as the total compensation structure mentioned earlier to ensure it is able to meet the demands these changing cycles impose without having to "recreate the wheel" every time.

What becomes apparent as we juxtaposition these issues is that compensation development is really a combination of science and art. Data is useful and modeling helps an organization test and anticipate what might happen under different scenarios. However, organizations have to be able to measure the rewards strategy's impact on the minds and hearts of their workforce and whether their pay approach is leading to higher levels of engagement and commitment. Simultaneously, they have to be able to gauge the impact of any plan's implementation on shareholder value, the business model of the company and the long-term vision of the owners. That's another reason a total compensation structure and planning phases are a good marriage. They provide the framework for bring art and science together.

The Compensation Allocation

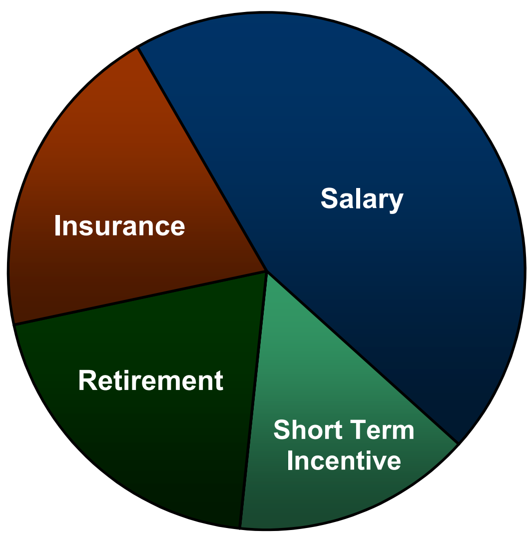
When all is said and done, rather than seeking some kind of magical pay plan, a company should be striving instead for the right compensation *allocation*. It needs an effective means of evaluating "how" its employees should be paid—not just "how much."

Compensation is one of the largest deployments of capital a company makes every year. It is an investment. As such, it should be organized into asset classes in much the same way a personal investment portfolio is constructed. Each category has an intended purpose. The asset classes potentially associated with a comprehensive rewards program might look something like the following.



Note that not every "asset class" will be used by every organization. However, most companies don't use enough of the options available to them to create an overall strategy that will have a significant impact on performance. Again, each company's allocation will be different and may be changed during given economic or business evolution cycles—as they should be. But it should give consideration to all of the options before arriving at a final apportionment.

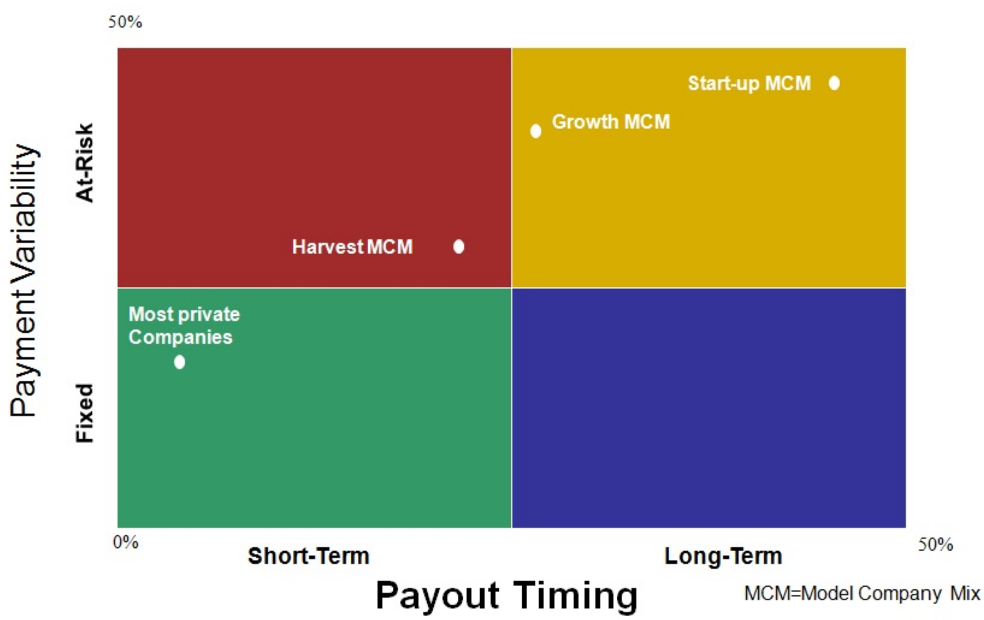
The allocation for most organizations that haven't developed a strategic and comprehensive view of compensation planning looks something like the pie chart below.



Note the emphasis on guaranteed compensation and the short-term focus on value-sharing. Chances are, this organization needs to think about a mix of pay elements that more effectively defines the range of results the company wants its people to achieve. While that might vary in terms of the amount allocated to each asset class, it is likely that more pay categories are needed. For example, if the company has a growth plan over the next three to five years (as our sample companies do), there should be some element of pay that speaks to that target—such as a phantom stock plan, profit pool or other long-term value sharing arrangement.

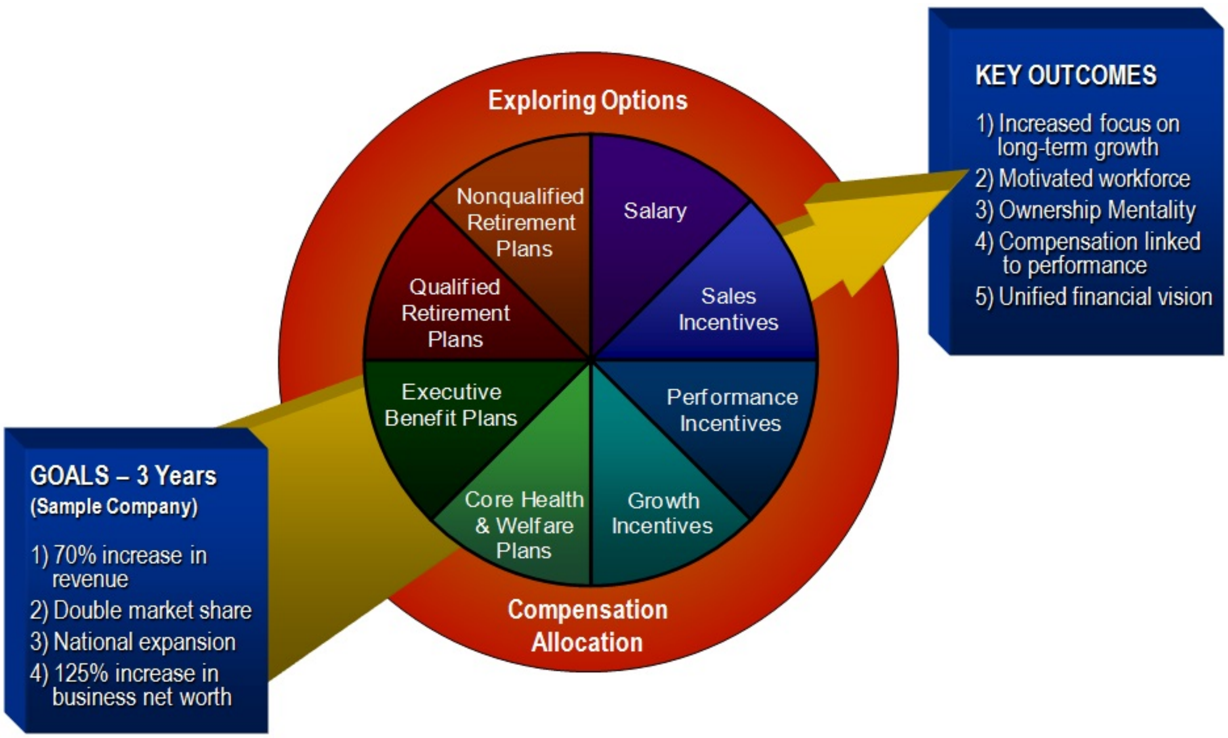
Those planning compensation with the investment model in mind ought to consider how the combination of guaranteed versus variable compensation and short-term versus long-term value sharing should interact with each other. If we were going to graph it, we might start with two axis that look like this.

The consideration of these four elements facilitates a balanced approach to compensation design that can be adjusted for the different business cycles mentioned earlier. It is also where the need for a combination of art and science comes into play in pay engineering. There is no one allocation that is going to be "right" every time. However, as a general rule, the compensation portfolios of different cycles might look something like the following:



The key principle being illustrated here is that effectiveness in compensation depends on *how* people are paid, not how much. There isn't one plan design or amount of money that makes people perform differently. Rather, the overall compensation strategy needs to create alignment between pay and both the short and long-term growth goals of the organization. It must support the revenue engine of the company while also keeping key performers focused on the future business yet to be created. It must meet satisfactory market pay standards for guaranteed income (salaries) but provide upside potential that is effectively tied to performance metrics and growth markers.

As a result, in each of the planning phases mentioned earlier, company leadership should be continually evaluating its compensation investment allocation, just as it would do with an individual wealth portfolio. As it considers options, it does so with an eye on the outcomes it seeks to achieve (both short and long-term). Those outcomes are, in turn, tied to the growth goals of the organization as illustrated in the example shown in the graphic below.



Conclusion—There is No Such Thing

Coming full circle, we conclude that there really isn't such a thing as a "most" important compensation program a company can have; at least not one that applies to all organizations. The three companies talked about at the outset possess unique cultures and distinct ambitions despite their similarities. They must each measure where they are in the business and economic cycles we've discussed. They must likewise determine which phase of planning most applies to them "right now." Ultimately, they must build a balanced compensation "portfolio" that supports the outcomes and growth objectives each company seeks to achieve.

So, in setting compensation priorities, organizations would be wise to keep the following principles in mind:

1. **Ask the right questions.** Determine where your starting point is by assessing how clear the company vision is, whether or not there is a definitive pay philosophy, evaluating your salary structure and determining which kind of incentives you need in place.
2. **Build a Total Compensation Structure.** Creating a framework in which every kind of pay plan that might apply can be examined in context will help you see where the gaps are and establish subsequent priorities.
3. **Transition from incentives to value sharing.** It's a subtle difference but the concept of value sharing is rooted in the belief that variable pay should be self-financing. The company should pay value out of a "productivity profit." This simply means it is only earned and distributed once it has been created. And it's shared with those who helped create that value.
4. **Adopt a total rewards approach.** This means that that company recognizes compensation is only one of four different rewards elements that have to effectively addressed if great talent is going to come into an organization, then stay and perform. The company must have a compelling future, a positive work environment, opportunities for personal and professional growth, and financial rewards that instill and support a unified financial vision for growing the business.
5. **Use planning phases.** Structure compensation planning in the four phases that were outlined earlier so there is a logical sequence to each piece that is put in place. Do so, however, within the framework of a total compensation structure and consistent with the company's pay philosophy.
6. **Treat compensation as an investment.** This means the company looks at pay in terms of asset classes that work together in generating a total compensation investment return for the shareholders. Each piece (asset class) has a different role but the combined portfolio should move the company towards its growth targets.

Ultimately, a company will feel more in control of its pay decisions if it uses compensation as the strategic tool it should be. Assuming one plan can magically transform the organization or address every results objective the company has is really folly. You probably knew that before you started reading this paper—notwithstanding its title. However, if you approach compensation development properly, *every* plan you have will fill its role effectively and help align your talent with the key growth objectives of the company. Done effectively, the result will be the creation of a unified financial vision between ownership and its workforce.

About the Author

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Ken has been consulting with middle-market private and public companies on executive compensation and benefits issues for over 30 years. In addition, he has authored numerous articles and white papers addressing compensation and rewards topics that modern businesses face. Ken also conducts monthly webinars for business leaders and CPE training webinars for CPAs on compensation best practices. His client work centers on the development of overall compensation strategies designed to enhance and improve shareholder value and workplace productivity. He is one of VisionLink's six principals.