Variable Compensation for Family Businesses

By
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One thing is very clear: The use of variable compensation plans is increasing in virtually every industry. Companies that do not have them are implementing them. Companies that use variable pay for executives and sales only are expanding them to other sectors of the business. They are doing this for some good reasons.

(INSERT FIGURE 1)

Executives in every industry face two common problems. First, they need to make their companies more competitive, by reducing costs, improving customer service, expanding product lines, or entering new markets. These strategies require people to do things that are likely quite different from what they do today. Variable compensation plans, along with other types of rewards, can create a meaningful stake in achieving success, and thereby encourage and reinforce those efforts that enable the company to prosper. Without a direct connection between performance and pay, why should people really care about the executive's priorities, unless there is a personal relationship with the company?

Second, family businesses, many who are smaller than others in their industry, need to compete for talent just like everyone else. While family businesses offer many attractive features, such as its size, location and flexibility, they often cannot offer the same salary and benefit programs of larger companies. While money is not the only consideration for people to join or remain with a company, it is often very very important. Variable pay programs offer people the "opportunity" for additional pay, if they and the company are successful. This cannot only increase the absolute level of take home pay, it can provide people with symbolic, personal benefits for the action they take. This makes the company more competitive in the marketplace for talent.

But, variable pay programs are not for everyone. While this author cannot often understand why a firm would not develop such a program on its basic merits, there are sound reasons for caution. First, if the organization is undergoing significant change in the structure, ownership interests, or location, time is probably no right for implementing such programs. Second, if the top executives are unwilling to share goals, strategies, and information with people, and prefer to operate in a command and control manner, then progressive variable pay programs will not be effective. Finally, if the nature of the business provides people with little opportunity to affect the factors that lead to a firm's success, then a variable pay program will only serve to frustrate people when conditions are unfavorable or in appropriately benefit them when times are good.

In this author's experience, unacceptable reasons include:

1. The company does not want to share sensitive financial information,
2. The company or several executives had a bad experience with a program in the past or with another company,
3. The company is either too large or too small to develop these programs,
4. The company does not have the systems in place to track performance (this may cause reasons to progress slowly, but not an excuse for why they cannot be done),
5. The company is not doing well financially, and needs to get into a better position with the market, customers or products before a plan can be instituted.

There are critical reasons that underlie these "excuses" that need to be address in how the program is designed and managed. When one considers developing a variable pay program there are several important considerations. This chapter will provide guidelines for the basic decisions, and the reader is encouraged to either continue the research with additional readings (see the reference section at the end of this chapter) or seek outside assistance. Some of the best efforts are ones that involve people within the organization in working through the key issues and developing a program that is suited for the unique situation of the company.

Develop the Purpose and Key Objectives

To provide a brief definition, a variable compensation program is a pay program that provides a bonus or special payment to individuals in addition to their salary. The dollars are not added to the salary (like a pay increase), and the amount is based on a pre-determined set of objectives, formula or criteria. If people achieve these results, then they receive their payouts. If they don't, then there are no payouts.

Any important program needs a clear purpose and objectives. This serves to focus efforts and provide a quality control framework for evaluating the program's design and effectiveness. Further, these statements often reflect the underlying philosophy of management and provide a very useful background for communicating to the program's participants.

Many purpose statements and objectives have common themes. You should consider which are most important to your company. Some of these objectives are:

1. Focus employees on the key success factors of the business.
2. Provide a share in the success the company realizes from high performance.
3. Encourage teamwork and collaboration within the company.
4. Encourage personal initiative and implementation of new ideas.
5. Reinforce continuous improvement efforts for all.

6. Provide an opportunity for people to increase their income as the company grows and remains successful.
7. Build a bridge across all levels and areas of the company, where all people benefit from the contributions of each person.
8. Increase the firms' ability to attract and retain new talent.

Types of Variable Pay Programs

There are many types of variable pay programs. A discretionary bonus program may operate somewhat like a variable program, but it does not fit our definition. In these programs the executives determine who get bonuses on subjective or after-the-fact criteria. The key issue is these programs do not clearly articulated the measures and goals at the beginning of a performance period, and the payout may reflect one's relationship over performance.

A profit sharing program is variable pay program. In these programs, the executives establish a threshold of profitability that needs to be achieved, then create a pool based on an establish percentage at or above this threshold (e.g., 10% to 30% of profits over threshold). Then, the pool is distributed to eligible members of the company evenly (as a percent of their salary) or based on individual performance. Some companies use profit sharing to contribute to individual retirement accounts; others make a direct payment. Either could be appropriate depending on what is meaningful to the participants.

The primary advantage of these programs is that they are self-funded. The pool is created from an overage above threshold profits, and then distributed to employees on a proportional basis. The primary disadvantages are that people often lack clear control over many factors that impact profits (e.g., pricing, supply costs, operating costs, capital investments, etc.), and the company may need to provide sensitive information on a frequent basis to people in the company. In addition, while an ultimate measure of a firm's success is its profits, these programs do not provide focus to the drivers of profitability. People may make short-term decisions to increase profits that have negative long-term consequences for growth, sustained profitability, and return on investments. These are often critical issues in a family business.

Team incentive programs include Gainsharing and Goalsharing. In brief, each of these programs often uses multiple measures, and if threshold levels of performance are achieved, individuals receive a payout. In a family business where many financial measures are highly sensitive, these programs can focus on other types of measures, such as those that reflect increased volume, reduced costs or improved services. This protects the private information while getting people to focus on the performance drivers.

Gainsharing uses manufacturing type measures (productivity, costs, safety, etc.) and the payouts are based on a formula that shares a portion of the gain between employees and the company. Goalsharing, developed and applied very successfully in companies like Corning and Allied Signal, uses a set of balance measures (financial, operational, customer impact, etc.) to define a range of goals. Based on the performance in each measure, a payout is determined in relation to goal achievement. In both cases, individuals who make up the team, business unit or company, receive essentially the same amount in relation to their salary.

The primary advantage of these programs is in how they clearly define the performance measures and provide payouts in relation to achievement. Gainsharing tends to be based on improvements over historical performance, where Goalsharing tends to be based on achieving desired performance. Further, by providing common payouts, these programs encourage teamwork, communication and continuous improvement. The primary disadvantage is the responsibility of managers to define measures, targets and communicate progress regularly. If people don't understand what they need to do to improve the performance of the team, then they respond with either frustration or ignore the program all together. Further, by using the unit's results to determine the payout, these plans place little emphasis on individual contributions.

<u>Individual incentive programs</u> are bonus plans that determines payouts based on performance against a set of personal objectives. In these programs, the individual should know one's payout opportunity if he or she achieves a set of objectives. This is the most common form of variable pay, particularly for executives and managers.

The primary advantage of these programs is having the goals or objectives based on individual performance. They can be tailored to each person's role and priorities within the company. Payouts can be clearly differentiated between those that make major contributions and those that make little effort or achieve the minimum. The primary disadvantage is that in order for these program to work effectively, executives need to set specific, meaningful objectives for each person in the company who is eligible for payouts. Many firms do not do a very good job here, and consequently these programs become another entitlement pay program. This happens when executives make payouts regardless of the performance. These programs also tend to discourage collaboration and communication across the company unless one can see how helping others will have a direct personal benefit.

There is clearly no single right way to approach variable pay programs. Each type has certain clear advantages and important limitations. Consequently, you will need to determine how to structure the program so that it addresses your critical objectives, and operates to reinforce the desired culture. In many cases, you can use a combination of these types, to achieve the right balance. However, with every program feature you add will increase the complexity of the program for understanding, administering or focusing people on desired actions.

Highlight of Key Design Decisions

To develop an effective variable pay program there are over 100 decisions one needs to make. Some are as simple as: Will the payouts be made quarterly, semi-annual or annual? Or, as complicated as: How will we measure, track and provide frequent feedback on performance?

The following provides a brief summary of the key steps to designing a variable pay program. The author recommends that you follow this order of steps, as the decisions in one step will impact the subsequent decisions. A brief summary of the decisions is provided in each step.

1. Purpose and approach

The discussion thus far in the chapter should assist you in defining the purpose and approach. This task should reflect important considerations of your business, the previous experience with variable pay programs, and what would be meaningful to your people. The key decisions include defining the purpose, primary objectives and determining the overall approach.

2. Eligibility

Determine who should be included in the program. Making the group too limited may minimize the costs, but it will have little effect on those that drive desired performance. Making the group too large may require a strong commitment to communication, goals setting, and coaching performance. Also, determine when new hires will be eligible as well as what happens to payouts for those who terminate employment with the company before payouts are made.

3. Performance Measures

There is an old saying: "Be careful what you measure and reward, you will get more of it." This is perhaps the most critical decision in the design of variable pay programs. The measures need to reflect what the firm needs to do to be successful, they must be easily understood by the participants and be within their ability to influence. There are many techniques for determining measures, and exploring them would go beyond the scope of this chapter. The key point to remember is that the measures should be easily understood, challenging and achievable. People need to see how their efforts are progressing to the achieving desired goals, and the payouts should be made in relation to the goal achievement.

4. Payout Mechanism

In this step you should detail the specific process for determining the payout levels. The mechanism should reflect the type of plan you are developing, and be set up so they can be administered in a reliable, consistent and timely. The reference materials will provide a variety of different mechanisms; keep the process simple but not simplistic.

5. Payout Opportunity

This step defines how much people will likely receive if they achieve desired performance levels. In most cases, payouts are expressed as a percent of an individual's salary. This means that the variable pay program provide an opportunity to receive additional income if certain goals are achieved. For new programs most companies do not reduce current pay, but they may reduce salary increases for a period of time until the desired mix of salary and bonus is achieved. Further, the payouts may differ by levels based on role, impact and marketplace practices. For example, common practices for administrative and operational employees are to have payout opportunities in the 5% to 10% of salary. As job responsibilities increase, a 10% to 15% to 20% would be more appropriate (these guidelines exclude executives, senior managers or sales). There should be a minimum payout level for threshold performance, a target payout for target performance, and high payouts for exceptional performance; it is often helpful to add interval steps to further encourage continual performance improvements.

6. Potential Costs, Funding Sources and the Return on Investment

Variable pay program operate with integrity when if desired performance is not achieved, there is no payout. If the company can achieve the desired performance without making payouts, then do it. Consequently the cost of these programs should be viewed as an investment to achieve the desired result. The company is protected from making payouts without performance. In planning the program, the costs should be projected in relation to achieving different levels of performance. Further, the payout opportunity should be meaningful to individuals, and encourage them to make the necessary changes in behaviors to achieve the results. Then, the payout opportunity targets should achieve a desired balance what the organization can afford and what the individual will find meaningful.

7. Special Issues

As you work on designing the program, a number of issues will emerge. This is now the time to resolve them. These may include: What do you do if you change prices, invest in new capital equipment, introduce new products, etc.? You should also determine if the payouts will impact any employee benefit programs that are sensitive to salaries (e.g., pension plans). Finally, if nonexempt employees are included in the program, then any payouts they receive will impact the base wage level for determining overtime. This is a requirement of the Fair Labor Standards Act. Planning for the costs and administration of this provision will be an important consideration.

8. Gaining Program Approval

The program design should now be complete. The next tasks will be to review with managers, legal counsel, and gain the acceptance of the company's owners. Hopefully, the owners or executives sponsored the program design effort, and the resulting program should meet their needs. If there is a strong interest, but equally strong hesitation, then the program may be pilot tested with a group in the company that has a high degree of interest and support for the program. The pilot should run for a relatively short but sufficient time period to find mistakes and implement solutions. This will prevent employees in other areas from feeling excluded from participation in this new compensation program. In final, the program will need a clear document that describes all the terms and conditions in simple, easy to understand (i.e., non-legal) language.

9. Plan and Execute Effective Implementation

To implement these plans effectively, there are three key elements. First, provide the type of communication that will capture people's attention, demonstrate the program is important to the company, and help people understand the program clearly. It is important to make the messages clear and up beat. Second, make sure you have set the performance targets, and have the systems in place for tracking and providing regular feedback to all participants. Like in sports feedback of the current score is essential to keep the interest and motivation alive. Finally, make sure that people understand what actions they need to take to win. This means translating the performance measures into suggestions or specific guidelines for taking action. If you let people try to figure it out on their own, they may not focus on the desired areas. Managers and supervisors are key for this task, and specific training may be needed to enable them to do this effectively.

10. Establish accountability and reviews for the program

Like every important management system (e.g., budgeting, order processing, purchasing, etc.), there are clear accountabilities and a commitment for reviewing and improving process. Someone important with the organization needs to make sure that the program is implemented effectively, that the program is effectively communicated, that regular updates of performance are provided, and that the decisions are made timely and with integrity.

Further, while most of these programs exist for several years, they should be reviewed and improved on an annual basis. Often our clients find that when they initially start with these programs, the first year is dedicated to learning the process and adjusting systems and actions to support the key goals. The initial program is seldom "perfect" and improvements need to be made on a regular basis. This is an important expectation, and it may likely take a few years before the system is fully integrated into the culture and operating process of the company. Take this time to experiment, learn and adjust.

Are These Plans Worth the Effort?

In our experience and research, all high performing companies find ways to creatively involve people to serve customers and improve the process of the businesses. Many use variable pay programs to either encourage these actions or reinforce them. When a company uses salaries only, they are left with few formal mechanisms for driving desired performance. However, variable pay programs do not run themselves, and are not effective if they are considered as a program independent of how the business functions.

Considerable commitment, effort and investment are needed to make these plans work. But every important system of management requires effort, so the question is: What are the benefits? Consider the following two scenarios of companies and their use of variable pay programs, and determine which is more desired:

Case Study A:
This company establishes its annual goals during a series of management meetings, and then communicates them to all members of the company. These goals include revenue growth, customer service, and operational improvement initiatives. Then, department managers develop unit goals and measures that define how their units will contribute to the company's goals. On a monthly and quarterly basis, the status of performance is communicated through a series of meetings and displays in the work area. Senior managers often meet with people to review special projects or initiatives that support the development of new products, strengthen the relationship with key customers, reduce waste/costs, and improve the work process. When projects are implemented, there is often a great deal of fanfare, and publicity about this work. This is not for a few, but involves many people in the company. At the half-way point during the year, their "GoalSharing Program" which is an incentive plan tied to company and unit goals makes a payout. This payout reflects a "progress payout" based on the achievements made to this point in the year. There is always an important celebration to go along with the payouts. These payouts are not a surprise, as people can calculate how they are progressing on the key goals on a monthly basis. At the end of the year, the payouts involve overall performance for the year. The executives and department managers review the "wins" and the "challenges" and what was done to achieve the results, or what prevented the achievement. This discussion serves to reinforce contributions of many, as well as learn what could be done differently. This also sets the stage for the next year's performance goals. The employees of this company feel like winners, because they and so is their company.

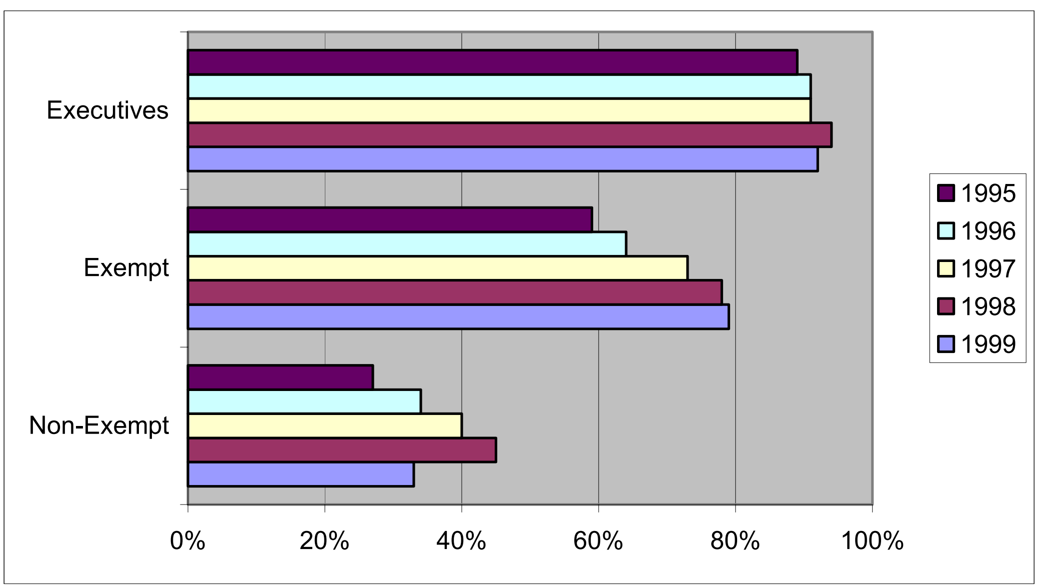
Case Study Two:
This company operates in silos. Each senior manager works with the President to set the goals for the year. Some of the managers are effective in communicating the goals down to down employees; others are not. People are often suspicious about other groups, and blame their problems on the failures of other departments. The company's bonus program exists for the top managers and the sales representatives only. There is little talk about goals during the year, although some managers are quite effective in setting personal goals; others are not. At the end of the year, near bonus time, people assess the opportunity for a payout based what information they have about the company's performance. They expect to receive about a bonus about at the same level as in previous years. They won't know until some months after the close of the fiscal year. Performance discussions are often characterized with conflicts and "year end crisis mode" as people seek to document how well they have done for the year. During this time significant energy is focused on internal operations, and the customer issues often take a secondary importance. This is they way this has always been, and people believe that this is the way things are in other organizations. They just continually fight to survive in a highly competitive marketplace.

What is the difference in these two companies? In short, variable compensation program is a reflection of the approach to management used in these two companies. The practices are reflected in their performance incentive program.

The marketplace for products and services is seldom forgiving. Companies make their own place, and their ability to lead the marketplace is often based on the people and the strategy they pursue. Capital, technology and location often provide only temporary advantages. A company with a strong strategy has the opportunity of becoming a winner in the market, but without the commitment, applied talent and initiative of its people, an "A Level" strategy will not become reality. Hence, the fundamental challenge to executives in times of uncertainty is to create an environment that is responsive, resourceful and effective in using the tools it has to win. In so doing, the company creates winners out of all that it impacts.

Figure 1

The prevalence of variable compensation plans over the last 5 years by employee group:



Source: Buck Consultants--*2000 Survey of Salary Practices*