



CAPTURE THE SPIRIT OF CONTINUOUS IMPROVEMENT

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April 24-25, 2007 • Hyatt Regency Indianapolis, Indiana



WINNING COMPENSATION MODELS:

PARTNERING WITH EMPLOYEES TO CREATE PERFORMANCE GAINS

By Brad Hill, Principal, Tandehill Human Capital

For all of the energy put into paying for performance, there aren't many companies that are doing it very well. This article offers five new rules to help organizations pay for performance, while respecting the dignity and contribution of all employees. It also offers you a glimpse into the IW Best Plants Conference session *Winning Compensation Models: Partnering with employees to Create Performance Gains*.

New Rule #1: Every \$1 in base pay increase will be viewed the same as a \$5 bonus.

Given limited funds, it is imperative that companies recognize the difference in value between a base pay increase and an incentive payout.

A base pay increase is a far more expensive reward than a lump sum payment, and too often, companies make the mistake of using base pay increases to reward one-time, annual contributions. The problem with giving an employee a 10% base pay increase for a really terrific year is that the employee earns that 10% every year for the rest of his/her career. A 10% base pay increase for an employee making \$50,000/year, who will be around another 10 years, is not just a \$5,000 increase. It is \$5,000 more pay each year for 10 years = \$50,000. And this simple example doesn't even consider the impact of compounding increase on top of increase, or the employee benefits that are tied to base pay levels.

Paying for performance means tying the term of the reward to the term of the accomplishment. Companies cannot afford to give base pay increases for short-term accomplishments, such as achieving annual financial goals or MBOs. These short-term accomplishments should be rewarded with one time, lump sum payouts. Base pay increases must be reserved for growth in skills, competencies and responsibilities.

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New Rule #2: Cost of living changes will have no impact on pay.

Companies have no guarantee that their sales, productivity or profits will go up by e.g., 3% next year, so how can they commit to raising their compensation expense by 3%?

Compensation is one of the largest expenses for most organizations and it is irresponsible to allow this category to increase every year at a rate that is unrelated to the performance of the business. Part of the reason companies are hamstrung in paying for performance is that they accept e.g., a 3% "cost of living floor" on wage increases. When there is a minimum 3% expectation, that doesn't leave much room to recognize the top performers.

New Rule #3: Compensation philosophy statements cannot use the words "attract, retain, develop, motivate," or "pay at market median."

There is nothing wrong with these words that have found their way into the pay philosophies of thousands of organizations, except that they are overused and empty objectives with no strategy behind them. If you want to pay for performance, the compensation philosophy must define what pay is and more importantly what performance is. A major steel producer offers a pay philosophy that states, "We will hire five people to do the work of 10 and pay them like seven." This philosophy is fresh, vibrant and communicates an above market pay practice closely tied to demanding performance standards. Companies may be better off with an Attraction Philosophy, or a Retention Philosophy, or a Development Philosophy that could talk about pay policy within a broader array of tools to attract employees, for example.

New Rule #4: Executive pay will be capped at a multiple of average worker pay.

Many organizations report that they cannot pay for performance with a 3%-4% merit increase budget, but then they turn around and deliver million dollar bonuses to their executive team. Perhaps part of the reason that companies have no money to differentiate performance throughout most of the organization is that they spend so much money trying to 'pay for performance' at the top.

A pay for performance culture starts at the top, but it doesn't end at the top. It must permeate the entire organization. We are not suggesting that executive pay be capped, only that total rewards maintain a balance between what the executives contribute to the organization and what the average employees contribute. Sharing the wealth is a healthy team approach that properly values the contribution of every employee, and can give every employee a role and a stake in the success of the organization.

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New Rule #5:
Broad-based incentives will be provided to all employees.
Somewhere along the way, pay for performance became synonymous with pay for individual performance. So incentive design principles focus primarily on the individual and the individual's span of control. Simplistically, a job is viewed as having individual impact,

department impact, division impact, company-wide impact, or some combination of these.

The problem with this approach is that it maximizes individual performance, while not necessarily maximizing company performance. Maximizing company performance is not achieved by getting every employee to perfectly perform the activities outlined in their job description. It is achieved by getting every employee to do all that they can to contribute to the success of the business.

The primary issue that many organizations have with broad-based incentives, like gainsharing or profit sharing, is that they fail to pay for individual performance. This is a legitimate concern. However, most companies already attempt to recognize individual performance with merit increases, promotions, special assignments, training, etc.

Broad-based incentives can be an insurance policy against the failure of change initiatives by providing all employees with an interest in the success of the initiative.

In allocating our annual rewards, there should be broad-based rewards for successful company performance, and individual rewards for growth in skills, competencies and responsibilities, and exceeding expectations.

Summary
Companies talk a lot about paying for performance, but few companies are willing to break with the traditional market pay practices that define and reinforce mediocrity. For the non-executive population, organizations choose to play it safe rather than develop an offering that will excite prospective employees and differentiate the company in the marketplace.

Pay for performance comes in two flavors, pay for individual performance and pay for company performance. The first should direct employees on how to maximize their contribution to the company, and the second should share the company's success with all employees. Following the five rules outlined above will help you to pay for performance by ensuring that: pay practices are fair and balanced; that pay is understood as an ongoing investment in people; every employee understands the value of his/her performance.

To hear more about this topic, attend the IW Best Plants Conference, April 24-25, 2007 at the Hyatt Regency Indianapolis, Indiana. The session—*Winning Compensation Models: Partnering with Employees to Create Performance Gains* will be held on Tuesday, April 24, 2007 at 11:10 a.m.

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MEET THE SPEAKER:



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Brad is a Principal with Tandehill Human Capital, a compensation consulting firm based in Chicago. Brad designs compensation programs in a variety of areas aimed at enhancing organizational and individual effectiveness including sales force effectiveness, group productivity incentives and performance management. Brad's work has recently been featured in *Fast Company Magazine*, *HR Magazine* and the *London Times*.

Before joining Tandehill, Brad was a senior consultant at the Hay Group for eight years. Prior to the Hay Group, he was a National Practice Leader-Variable Pay with Ernst & Young; a Principal with Watson/Wyatt; and consulted for Towers Perrin. Brad holds an MBA degree from the College of William and Mary and undergraduate degrees in Economics and Social Psychology from Cornell University.

He has been a Certified Compensation Professional (CCP™) of the WorldatWork since 1986, and has taught WorldatWork courses on Variable Pay and Elements of Sales Compensation. Brad serves on the Board of Directors of the Scanlon Leadership Network, a nonprofit association whose members pioneered gainsharing, open-book management, lean systems and servant leadership.

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