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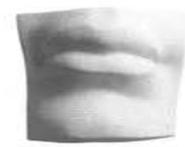


BIOGRAPHY

Author Brent M. Longnecker, CCP, CBP, CCC, is president of Longnecker & Associates, Inc., (longneckerandassociates.com) and a leading expert is strategic compensation, corporate governance and human resource planning. He has more than 20 years of experience in the analysis, design and implementation of innovative performance and productivity-enhancement programs. Longnecker also has been selected as one of the Top 25 Most Influential Consultants 2005 in the United States by *Consulting Magazine*–the first in the field of executive pay. His consulting engagements with compensation committees, attorneys, executives and others, in all industries, have embraced and dealt with a myriad of issues ranging from analysis to expert testimony; from incentive plan design to the design of compensation committee charters. He has authored over 200 articles and seven books.

Prior to forming Longnecker & Associates, Longnecker was president of Resources Consulting group, a spin-off of Deloitte & Touche where he served as national Partner-in-charge of Deloitte's performance management and compensation consulting practice.

Chapter One

Base, Variable and Performance-Based Compensation

Objectives

In today's corporate or business world, the competition for top talent is fiercer than ever. One of the primary fields of battle for top talent is the area of compensation. In order to compete and win in this area, companies must build and implement successful compensation strategies and reward systems.

Key points

◊ Base salary, short-term incentives, long-term incentives, benefits, and perquisites work in concert to provide the organization with an abundant supply of motivated employees.

◊ Corporate culture and organizational strategies must be aligned.

◊ The ability to effectively design multiple compensation strategies is key to the harmonization of strategy and culture.

Before exploring every nook and cranny of compensation, business leaders should first review corporate strategy and organizational design. Compensation is only a piece, although an important one, of the total organizational structure. Without a defined corporate strategy, compensation plans run a high risk of being unsuccessful.

The direction and intent of the company should be clear, focused and well communicated. If ambiguous, the person or team designing the compensation package should discuss and get consensus on the direction of the company with the company's decision makers (board of directors, owner, CEO, etc.) as a first step

The strategy of the organization is important because it greatly affects how the company is structured. Likewise, the design of the organization is important insofar as it supports the strategy.

> *Generally, management of a large force is the same as the management of a few men: it is a matter of organization. And to direct a large army to fight is the same as to direct a small one: it is a matter of command signs and signals.*
>
> —Sun Tzu

BEST PRACTICE

The Star model. A popular way of viewing the structure of an organization is the Star model attributed to Jay R. Galbraith. In this model, five areas are used to describe the characteristics of the organizational design. These five areas are:

- **Strategy**—an organized set of goals and vision which capitalize on those areas that are deemed core competencies by the organizational leadership.
- **Structure**—the formal roles of people in an organization. Structure involves concepts such as power distance (which is the extent to which less powerful employees accept that power is – and should be – distributed unequally) and chain of command.
- **Processes**—the actual method by which things get done. Typically, processes are viewed in macro terms as either top-down (resource allocation) or between departments (product development).

- **People**—the policies of the firm that relate to the procurement and development of talent in an organization.
- **Rewards**—a system that encourages employees to act in a manner that is consistent with the corporate strategy.

To these five parts of the Star model, some organizations also add an element which encompasses the entire star: culture. In order for a business organization to be successful, all elements of the organizational design must be in alignment. Corporate culture is seen as the glue that keeps the parts of the star aligned with each other through the employees' shared sets of values and experiences.

Because compensation is part of the toolset that adds vitality to the organizational design, the actual structure of the organization is important to the development of a compensation package. Compensation is a key piece of the People and Rewards elements of the Star model. Because of the way compensation is used to influence the types of people drawn to an organization, it is an important factor in corporate culture as well.

Once the organizational design is aligned with the strategy, the acquisition of talented employees that fit organizational needs becomes essential. Compensation is one of the primary means of attracting the right people. Once hired, employees need to be rewarded for their performance and productivity. Again, a well-designed compensation plan can provide this direction and incentive for employees.

DEFINITION

Compensation for the employee is defined by WorldatWork as the total sum (both extrinsic and intrinsic) economic benefit received by the employee in return for services rendered to the employer. For the employer, compensation can be defined as the cost of providing those economic benefits to the employee. This book will examine compensation from both the employee's and the employer's perspectives.

Compensation is critical because it is the primary means of attracting, retaining, and motivating talented employees. Of course, each piece of a compensation package plays a different role in contributing to the attraction, retention, and/or motivation. A discussion of these elements will be presented later in this chapter.

Typically, a discussion of compensation packages is centered around compensation for highly-compensated executives. Although some discussion of compensation for specific groups of employees will take place, most of this book will focus on executive and key employee compensation packages.

The definition of executive is somewhat nebulous. Different companies define the term differently, and some do not make a distinction between executives and other employees at all. Often, executives can be identified by title. Corporate officers are almost always considered executives. However, the best way of describing an executive is *anyone who has significant impact on the results of the enterprise.*

The groups of employees that will be discussed in this book come from a range of functions. These functions include hourly manual labor, middle management and, increasingly, "knowledge workers." Because the knowledge worker group is growing the fastest, most of the discussion that does not focus on executives will focus on this increasingly important category.

THE TOTAL COMPENSATION PACKAGE

The total compensation package builds off of the business strategy and serves as the roadmap to success in the building of reward packages. Further, WorldatWork teaches that there is a circular process that completes the total rewards cycle. (Figure 1: Total Rewards Cycle). It shows that any program designed needs to be in sync with both the mission and business strategies of the organization. The obstacle is to drive desired behaviors into a workforce that will enhance the chances of organizational success.

As stated previously, companies must have a well-designed compensation plan in order to attract, retain, and motivate talented employees. What is a compensation plan? A compensation plan should be viewed as the *total compensation package*. This approach is important because compensation is made up of several elements, which must work in tandem to meet all of the goals of the compensation plan. Taken individually, none of these elements are capable of

Figure 1-1. Total Rewards Design Process

Source: WorldAtWork

providing the means to completely achieve the goals of attracting, retaining, and/or motivating any qualified employee.

Employees view the total compensation package as a way to achieve a variety of personal goals. The package can provide a means to achieve a lifestyle, to accumulate wealth, to ensure security, and to boost self-esteem. By permitting the employee to achieve these objectives, the compensation package becomes a highly effective method of inspiring the employee to focus on the work ahead of them.

Employers tend to view the total compensation package as a cost or at best – an investment. They try to balance the package in a way that achieves the biggest impact with the employee for the least amount of actual cost. As well as a cost, total compensation can be viewed as a competitive advantage for employers. A well-designed package will allow companies to attract and retain talent that will provide them with a competitive edge. The proper package design will also give employees the incentive to reach higher levels of productivity than otherwise attainable.

What are the elements of a total compensation system? A total compensation package has five key elements. These elements are:

- Base salary
- Short-term incentives
- Long-term incentives
- Benefits
- Perquisites

Some elements are more effective in attracting new talent. Others provide incentives to retain existing talent with the company. The remaining elements help to motivate existing talent.

BASE SALARY

Base salary is typically the cornerstone piece of any compensation package. This is usually the key piece in the average compensation package. As employees reach more exalted ranks, the impact of base salary on the total compensation package is lessened.

Base salary in the United States has been impacted by several federal regulations:

- The Fair Labor Standards Act of 1938;
- The Equal Pay Act of 1963;
- Title VII of the Civil Rights Act of 1964; and
- The Age Discrimination in Employment Act of 1967.

The Fair Labor Standards Act

The *Fair Labor Standards Act (FLSA)* was passed in an effort to guarantee a minimum living standard for industrial workers and to curb abusive employment practices. The need for this type of legislation was publicized by the efforts of labor unions in the early part of the twentieth century. The FLSA made employers more responsible for treating workers fairly. Through wage guidelines, this legislation sets baselines for the salary portion of the total compensation package.

Minimum wage laws originated with this legislation. The minimum wage is the pay rate that organizations must guarantee their employees. This guaranteed minimum pay rate is a requirement regardless of the basis for pay. Pay must be distributed on an hourly, piece, or hourly-plus-tips basis. In all of these situations, the employee is entitled to a wage rate equivalent to the federal minimum wage set by Congress.

Another important concept relating to base salary introduced in the FLSA is that of exemption. The FLSA contains guidelines to differentiate between types of positions. These distinctions, which have become fuzzy in today's employment environment, are exempt and nonexempt.

DEFINITION

Exempt employees are typically in supervisory and professional positions and above.

Nonexempt employees are usually line employees such as assembly line workers or construction laborers.

The primary difference between these two classifications relates to the structure of the base salary. Exempt employees are paid a salary that is not dependent on actual hours worked. Nonexempt employees are paid hourly, piece rate, or some other wage rate directly related to the amount of work performed. The most important difference between the exempt and nonexempt categories is that exempt workers are not paid overtime.

The FLSA also includes provisions and guidelines for overtime pay. These provisions include a bump in pay rate for any time worked in excess of 40 hours per week. The pay rate for time in excess of 40 hours is one-and-a-half times the base pay rate. An important consideration to overtime pay is the impact of nondiscretionary bonuses. Even though nondiscretionary bonuses, which will be discussed in later sections, are not considered part of the base salary, they are included in the calculation of the base pay rate used to determine overtime pay.

The next three pieces of legislation—all from the 1960s—that impact base salary primarily target discriminatory, practices. During much of the history of the United States, hiring and pay practices were disparate, discriminatory, or inequitable. Typically, males of Northern European (but not Irish) descent were hired first and paid more than others. As the civil rights movements of the 1960s brought a level of public attention to the discriminatory employment practices of businesses, Congress enacted legislation in an effort to end the disparity in opportunities and pay.

Total rewards concepts have been introduced. New developments in the total rewards have been discussed. **Now what?** None of this information matters if it is not implemented.

How do human resource professionals know when to use this knowledge? They know by observation of the employees, the management, the economy, the competition, and the world in general. They ask questions of management, peers, and employees. For example, HR might survey managers if more structure or more flexibility is needed for the compensation program and survey employees to determine if they feel they are motivated to perform better as a result of the way the compensation program is designed.

In times of change, the rewards system should be evaluated. If disjoints occur throughout the company, re-examine the system. Typical signs include:

- Mergers
- Employee apathy
- Changing labor market conditions
- New competitors in the market
- New management
- Redefinition of corporate goals
- New government regulations

Since changes occur continuously, human resource professionals must **always** be examining the total rewards system. Opportunities can be maximized when someone pays attention at a critical time and can capitalize on the chance.

BEST PRACTICE

Introducing merger mania in compensation

Company name:	AstroClutch
Problem faced by company:	The total rewards design process at Astro began as a result of the merger between Astro and Clutch in 1999. During the course of the merger, a human resources conference was held to discuss the new company's direction. To meet the challenges of combining the two cultures and two compensation systems of the formerly separate companies, a choice was made to go beyond the former compensation systems of either company.
Compensation solutions:	The human resources team decided to develop a new total rewards compensation program. They chose to develop a flexible system that allowed the company to become "an employer of choice." Designing a "new" program fostered positive feelings about the merger allowing Astro and Clutch to be a part of something new rather than trying to adopt one of their current plans.
Benefit to company:	The new system enabled the company to alter the employer/employee relationship into a partnership. Employees were excited and motivated not only throughout the merger process, but about the future direction of the company.

Before implementing new ideas in compensation strategy, a baseline evaluation of the current system should be conducted. As explained in Chapter One, the compensation package is a piece of the entire design of the organization. Therefore, the examination of the compensation strategy should begin with an examination of the organization. This review must examine the needs of the entire organization and how the compensation strategy is aligned with those needs. A thorough evaluation will highlight the elements that are working and those that are not.

Before discussing the evaluation of a total rewards program, a review of the total rewards process is in order. This process can be used as reference throughout the total rewards evaluation and as a framework for any change implementations. Any review of the total rewards design process must first examine the factors affecting it.

FACTORS INFLUENCING THE TOTAL REWARDS DESIGN PROCESS

Internal and external factors influence the rewards program design process. Some of the external factors, including globalization, technology, and labor market characteristics, were discussed in Chapter One. Internal factors such as corporate culture, cost issues, and ownership expectations are detailed below.

ORGANIZATIONAL CULTURE

DEFINITION

The culture of the organization is defined as the shared beliefs and values of the members of an organization.

The culture is built around a set of shared assumptions. Members of the organization share values and behaviors. Often, the organization may have cultural symbols to further bind the members together. Various ceremonies and rites such as award ceremonies or public recognition may also serve to reinforce the culture.

Cultures come in different varieties. Some companies may be more entrepreneurial, while others may be more bureaucratic. The culture of successful companies typically binds employees together with the same goals. Southwest Airlines is famous for its "us against the world" and employee-centric culture.

COST ISSUES

Cost can significantly influence the design of a rewards program. Costs come in many varieties:

- **Time**—related to the costs of using the people involved in the design, review, and approval of the program
- **Implementation**—includes the administrative costs of the program as well as the costs relating to the communication of the program to employees

- **Funding**—includes any plan contributions or premiums. Funding issues may also include trust fund establishment and maintenance
- **Compliance**—consists of costs related to meeting federal or local regulations
- **Budgeting**—decides the total amount of funding available to the rewards program. This also includes the parameters for various items inside the program
- **Support staff**—includes the personnel needed to effectively establish and administer the compensation program

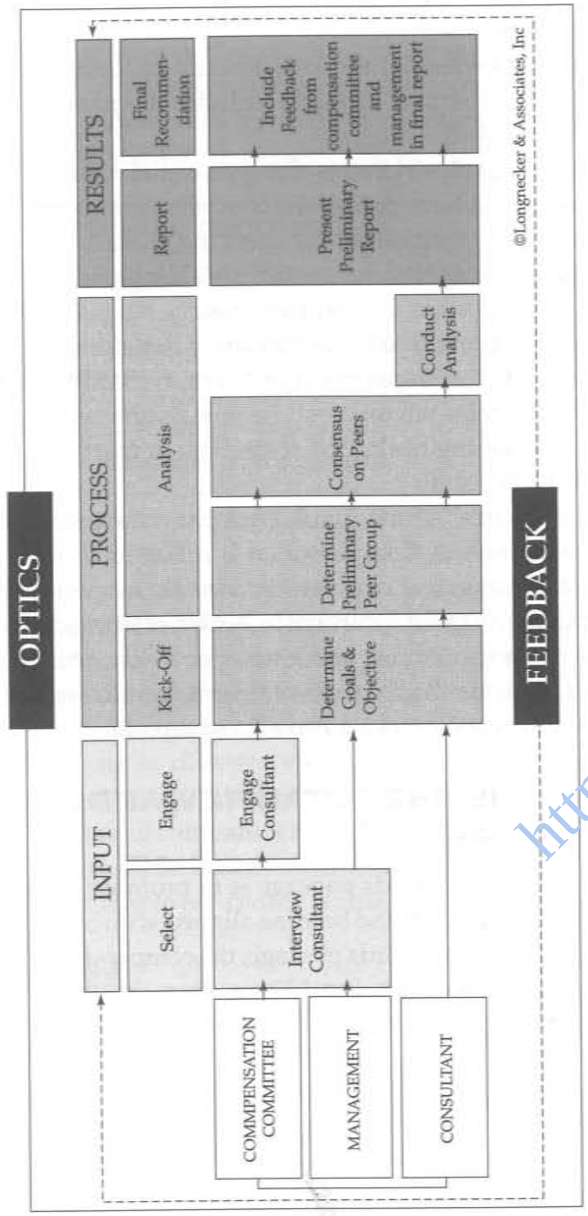
Budgeting considerations affect the guidelines for base pay and benefits. The pay structure establishes the parameters for the salary costs of jobs within the company. Salary ranges provide additional guidance for individual compensation decisions. Benefit programs, according to the Department of Labor, typically add about 40 percent to the total payroll cost. Benefit programs are rising in costs due to increasing healthcare costs. Benefit costs are also affected by demographic shifts.

Cost-control efforts involve proper adjustments of compensation and benefits. Compensation is adjusted to reflect the current or market pay rate. Costs associated with compensation can also be computed to predict future costs. Benefit offerings are often adjusted for the best mix of cost and employee value. Sourcing of benefits, which is evaluating the costs of several benefit vendors, is the most important cost control for benefit management.

WHAT IS THE TOTAL REWARDS DESIGN PROCESS?

The intent of a rewards package is to promote employee behavior that will accomplish and become aligned with organizational goals. Before building a rewards package, the company must define specific achievements to target. In addition, there should be a smooth, well thought-out process that positions one for success. (Figure 3-1)

Figure 3-1.



PHILOSOPHY, MISSION, AND STRATEGY

The first step of the design process is to evaluate the corporate strategy. The strategy of a company is actually a product of the company's philosophy and mission. These elements are set by the ownership and upper management of the organization.

DEFINITION

An organizational philosophy is the often informal set of beliefs and values that provide the core essence of the organization. The purpose of the philosophy is to provide a guideline for how the company approaches business.

Spawned from the corporate philosophy is the mission statement. This is a formalized pronouncement of what the organization is about, what is important, and how it approaches the world. Mission statements are used by management to display organizational direction.

The typical mission statement identifies the stakeholders of the company that might include customer/clients, vendors, employees, and shareholders/owners. It answers the questions: What is our business? Why do we exist? Where are we headed? Additionally, it may detail the market space or product. This example of a mission statement combines these elements with a plan for how the company is going to accomplish the broad goals:

> *Our goal is to become the supplier of choice to the home improvement industry. By supplying top quality products, delivering excellent customer service and working in partnership with our customers to satisfy their needs, we aim to be the best. As we see it, that's the best way we can properly serve the long-term interests of all our constituents: customers, suppliers, employees and stockholders.*
>
> —Ply Gem Industries, Inc.

The business strategy is the actual plan for achieving the mission while following corporate philosophy. Strategy is the broad scheme for positioning the company's products and services in a way that accomplishes the mission. The development of the strategic plan is usually more involved than defining the philosophy and mission because the strategy must cope with a greater set of variables. The strategy must also be checked for consistency with the corporate philosophy and mission statement.

Many different elements converge to form the business strategy, which is why the construction of the plan requires a cross-functional team. Some of the elements of a business strategy may include:

- Pricing
- Quality
- Innovation
- Research and Development
- Service
- Adaptability
- Finance
- Product or Service Differentiation
- Rate of Return
- Costs
- Target Market
- Sales Structure
- Marketing Techniques
- Production Methods
- Product
- Logistics

Research indicates a strong correlation between organizational performance and mission statements that define purpose, values, behavioral standards, intent to satisfy stakeholder groups, and competitive strategy.

Typically, a company decides which elements are critical to the successful pursuit of the mission statement. For example, a network integrator may focus on providing cutting-edge technologies (innovation) with high availability (quality) and high value (rate of return) for the customer.

The strategy of an organization sets the tone for the rest of the organizational design. The elements of the design must align with the rest of the organization. Human Resources can act as a major reinforcement for this alignment by attracting, retaining, and moti-

vating talent that supports the requirements of the corporate strategy. Therefore, the next step to reward system design is the development of a human resource philosophy.

BEST PRACTICE

Dealing with change

Company name:	HCC Corporation
Problem faced by company:	Due to industry changes, HCC was facing many dramatic changes in its organizational mission, structure, and composition which was leading to a misunderstanding of corporate goals. The result was high turnover and low productivity.
Compensation solutions:	HCC first redefined the company's new goals and strategies. HR programs could then be destroyed or redesigned in support of the company's new direction. During this process, it was evident that some positions would need to be eliminated. A career transition program was created to assist those employees who were being transitioned out. The program provided for severance and career counseling. For those employees who were to remain with HCC, a change management program was implemented, which focused on job education and job progression.
Benefit to company:	Employees understood the mission and changes encompassing HCC and worked diligently to ensure HCC was positioned for the future. In addition, those employees who were transitioned out were treated with dignity, maintaining HCC's excellent public image.

HUMAN RESOURCE PHILOSOPHY AND STRATEGY

As with the overall corporate strategy, the human resource strategy begins with a philosophy. The philosophy toward human resources consists of the values and beliefs applied by management toward its relationships with employees. The human resources philosophy and the overall business strategy are used to synthesize a human resources strategy.

The human resource strategy is the plan to gather, keep, and inspire talent. This plan is the set of broad guidelines that includes the rewards package, "customer (employee) service," and other initiatives. The largest element of human resource strategy is the rewards package that leads to the development of a total rewards

CHAPTER FIVE

ATTRACT AND RETAIN STAR PERFORMERS

OBJECTIVE

To continue the discussion of the importance of compensation to the success of a company, our focus moves from the overall culture to individual workers. The workers who are the lifeblood of any organization are its star performers. They generate the most new ideas and the most new business. The success of any company depends on its ability to attract and retain these star performers.

KEY POINTS

◊ Companies are always looking for new and better ways to attract and retain star performers.
◊ Most companies are now seeking new strategies for using long-term incentives to retain top talent.
◊ Job satisfaction has become the most important piece in attraction and retention.
◊ Individually customizable compensation plans are becoming the primary method to attract and retain top talent.

Attracting and retaining star performers has become more difficult in today's economic environment. Despite negative economic indicators over the past several years, such as fewer IPOs, reports of companies cutting back, loss of stock value, and layoffs, the unemployment rate has been mostly unaffected. This rate is only just now creeping toward 6 percent, which in relative history is still low.

Despite the overall market decline, certain companies have still retained much of their market capitalizations. The companies that maintained their valuations had one thing in common—the quality of their labor forces. The premium in market value is the human capital premium, somthing that is not captured on the balance sheet. The human capital premium is largely a function of star performers.

Consequently, companies are increasingly looking for ways to attract and retain star performers. Since company performance has come under increased scrutiny from stockholders, star performers can help ensure that the company is profitable and well positioned when the economy begins to surge forward.

The best companies encourage all employees to be star performers. This improves the performance of the company and reinforces the view of employees as the most critical assets of the company.

UNDERSTANDING STAR PERFORMER NEEDS

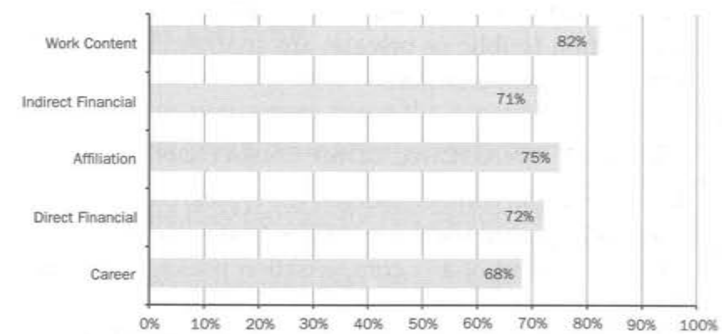
Recent studies indicate job satisfaction has become the most important piece in attraction and retention. In a 2000 New York Times poll, 72 percent of those surveyed chose a lower-paying position with high personal satisfaction over a high-paying job with little personal satisfaction. This emerging trend causes employers to look at compensation differently.

While compensation is a critical component to attract and retain star performers, recent data indicates prospective employees look at factors beyond the size of the paycheck. WorldatWork's 2000 Rewards Study, shown below, identifies several important categories that employees value. Employers need to adjust compensation plans and corporate work environment to better meet the needs of their employees.

Figure 5-1. *Overall Results—Importance*

Source: Rewards of Work, by Paul W. Mulvey, Gerald E. Ledford and Peter V. LeBlanc, WorldatWork Journal, Volume 9 Number 3, Third Quarter 2000.

Figure 5-2. *Overall—Satisfaction*



Source: Rewards of Work, by Paul W. Mulvey, Gerald E. Ledford and Peter V. LeBlanc, WorldatWork Journal, Volume 9 Number 3, Third Quarter 2000.

WORK CONTENT

Work content is highly valued by employees. Most individuals want to do something meaningful by working for companies that have a mission or vision that fulfills a purpose larger than profit. Employees also prefer a variety of work to avoid boredom and stagnation. For the same reasons, many individuals like for their work to be challenging. Autonomy is also highly prized by those who want to be treated like an adult at work, with the attendant responsibilities. Employees also want to give feedback that is actually put into use.

BEST PRACTICE

Southwest Airlines exemplifies the type of attitude and culture that meets the work content needs of star performers in its mission statement:

"We are committed to provide our employees a stable work environment with equal opportunity for learning and personal growth. Creativity and innovation are encouraged for improving the effectiveness of Southwest Airlines. Above all, employees will be provided the same concern, respect and caring attitude within the organization that they are expected to share externally with every Southwest customer."

INDIRECT FINANCIAL COMPENSATION

Indirect financial compensation such as benefits and perquisites are also valued by employees. Extra paid vacation days and noncash recognition (public or private) are another commonly used forms of indirect compensation.

DIRECT FINANCIAL COMPENSATION

Direct financial compensation is the typical basis for any compensation package. A market competitive base salary is the nearly mandatory component of any compensation package. Incentives that are linked to various corporate or individual goals are also popular, while ownership in the form of stock grants and options have also been used heavily over the last decade. Other forms of direct financial compensation include cash recognition and premium pay. The next section focuses on specific compensation components utilized to attract and retain star performers.

CAREER

Career progression is also very important to employees. In order to stay motivated about the work that is being done, employees like to believe that their career paths are headed to even more fulfilling positions. Most career issues relate to security and growth. All employees are interested in both groups, but the weighting varies from person to person. People that are focused on security want to be employed and want career consistency. Those focused more on growth want to have advancement opportunities, advanced training, and personal growth experiences.

TRADITIONAL COMPENSATION TO ATTRACT AND RETAIN STAR PERFORMERS

BASE SALARY

In order to properly use base salary as an important piece of the compensation structure, market rates must be established. Pay rates for average employees must be consistent with corporate compensation policy (*i.e.*, 50th percentile, 75th percentile). Star performers with a proven track record typically command base salaries from 75th to 90th percentiles.

ANNUAL INCENTIVES

While competitive base salaries are an integral compensation component, star performers place the greatest emphasis on pay-for-performance programs. Annual incentives, which are typically performance based, are a significant element of the compensation package because they provide the star performers a method to measure themselves. Star performers want the compensation to be linked to their performance because they believe heavily in their own ability to perform and thrive on the tangible recognition of high achievement on the job. Some common annual incentives include:

- **Spot bonuses**—effectively reinforce desired behaviors by immediately recognizing the employee through a non-recurring cash payment.
- **Periodic bonuses**—bonuses that are typically disbursed annually, semiannually, or quarterly based upon established performance

metrics, such as revenue targets, earnings targets, or even nonfinancial measures such as customer satisfaction, attendance policies, etc.

- **Discretionary awards**—ensure rewards for the true star performance in spite of outside economic factors, such as poor business, industry, or economy performance. These awards should accrue at 1 to 5 percent of payroll and be awarded outside the normal bonus pool.

BEST PRACTICE

Spot bonuses for star employees

Company name:	The Widget Company
Problem faced by company:	The Widget Company began experiencing high turnover among the ranks of its star performers. The company's major concern was how to keep key employees from leaving the company and seeking employment with competitors. In addition, the company was motivated by the knowledge that the cost of replacing talent is even more than the cost of retaining talent.
Compensation solutions:	In any environment where the loss of key people is disrupting the normal flow of business, companies can address the problem through various cash and non-cash retention programs. The first step in the process is to identify the star employees. In order for retention programs to be an effective use of corporate assets, care should be taken to ensure that the participants are truly the top talent employees that consistently excel. Spot bonuses were awarded to star performers, which enabled the company to recognize specific employee efforts without a permanent incentive program expense.
Benefit to company:	By implementing a spot bonus program, the Widget Company was able to retain its star employees and motivate other employees to perform on "star" levels.

LONG-TERM INCENTIVES

Long-term incentives are also an important part of compensation for star performers. Long-term incentive plans have historically been the premiere tool for retaining top talent. The heavy usage of stock options as a compensation tool in the 1990s has led to two trends:

- The prevalence of long-term incentives has undergone tremendous growth in the last decade.

> *"We can look back at 1990 and estimate roughly a million option holders and look at the present day and estimate roughly 7 to 10 million option holders ..."*
>
> —National Center for Employee Ownership

- Equity compensation has become engrained in the culture of many high-tech and start-up companies as a method of attracting top talent due to the reliance on stock options.

However, the current legislative and economic situation is revolutionizing the use of long-term incentive programs. Specifically, after the bursting of the technology bubble, many stock options became worthless. The resultant loss of value made them useless as a retention tool. Along with the older options being underwater, or of no value, new option awards require higher quantities to be given to maintain commensurate value. This leads to overhang issues (the perception of too many shares awarded and reserved for employees as a percentage of total shares outstanding). Additionally, FASB's decision to require the expensing of stock options makes stock option use problematic. Most companies are now developing new strategies for using long-term incentives to retain top talent.

BEST PRACTICES TO ATTRACT AND RETAIN STAR PERFORMERS

As the competitiveness in attracting top talent increases, certain best practices have surfaced. These practices include:

- Employment agreements
- Signing bonuses
- Wealth accumulation through restricted stock awards
- Phantom stock plans
- Nonqualified deferred compensation plans, and
- Other innovations directed at enhancing the employee's quality of life.

of the position. Also, the format and parameters for measurement are dependent on the level of the employee.

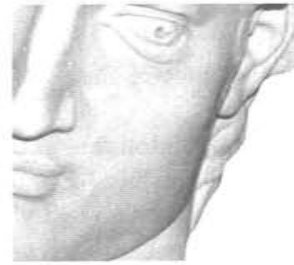
The group that typically receives the largest payout from rewards programs is the executive group. This group participates in both time horizons of rewards more often than other employees.

Two main categories for variable compensation are annual incentives and long-term incentives.

Annual incentives. Annual incentives are the near-term element of variable compensation. Typically, this group of incentives is disbursed in cash as a reward for short-term performance. This is primarily an individual performance measurement at the lower levels in a company. Higher up the corporate ladder, short-term incentives are increasingly based on group or organizational measurements, which are very often quantitative measurements such as net income. Targets for annual incentives must be set early and well communicated so employees have a reasonable opportunity to meet performance goals. Payout for short-term incentives must be timely to reinforce the linkage between the reward and the desired behavior. Payouts for annual incentives are typically expressed as a percentage of the base salary.

Long-term incentives. Long-term incentives are linked to longer-term goals. Rewards can be much larger than for short-term achievements. Long-term incentives are intended to align employees, especially executives, with the interests of stockholders. Optimally, employees will be encouraged to work toward an overall direction. Part of the intention of long-term incentives is to prevent the sacrifice of the long-term good for short-term results. This type of incentives is more frequent among executives, but trends are suggesting that employees at all levels are becoming increasingly involved in long-term incentives.

Many different methods are available for use as long-term incentives. Cash is sometimes used, but typically equity or equity equivalents are used in long-term rewards. One of the best tools to use for this type of reward is restricted stock, because stock options, the primary method of the last few decades, are under media, regulatory, political, and investor scrutiny.



CHAPTER SEVEN

WHEN THE BEST SHOULD EARN THE MOST

OBJECTIVE

Paying for top performance is a compensation philosophy many organizations discuss as a critical component to success. Therefore, it is no coincidence that the highest performing companies adhere to the philosophy: *reward the best, push the rest.*

KEY POINTS

◊ Rewarding great performers is the best way to motivate and retain top talent.
◊ The best employees should be rewarded while the remaining employee population should be pushed to become the best.
◊ *Reward the best, push the rest* should be part of a compensation philosophy that directly links to the goals and objectives of the company by incorporating performance management.

Rewarding "top-performing employees" does not mean rewarding solely high-level employees. Organizations are using performance pay for middle managers, professionals and hourly workers, determined not to let the depressed business climate lead to a depressed workforce.

—Steve Bates

Rewarding great performers is the best way to motivate and retain top talent. These are the people most responsible for the achievement of organizational goals and they should be rewarded in an appropriate fashion. Everyone else should be encouraged to become top performers by the example of the rewards given to the top people.

A Watson Wyatt survey found that companies providing variable pay to their best workers are 68 percent more likely than other firms to report outstanding financial performance (Bates). While this statistic may be a positive correlation in itself, it is likely this statistic is indicative of a management style with a human resource focus that recognizes pay-for-performance as a key component to attract, retain, and motivate outstanding people. The variable pay/outstanding financial performance correlation is also supported by the belief that top talent prefers variable pay as a way to acknowledge high levels of performance.

VARIABLE REWARD ALTERNATIVES

Two-thirds of U.S. companies currently use some sort of variable pay. However, it's being used for fewer employees, but those receiving it are getting more. Historically, in the 1980s and into the 1990s, all employees received a standard salary increase of 8–10 percent and any drop below that level would cause resentment. However, since 2000, the average employee salary increase has dropped to approximately 3–4 percent. Companies are no longer relying on plain vanilla, across the board merit increases. Instead, companies are increasingly relying on performance rewards to provide additional compensation opportunities for star performers, while average and below average performers are receiving a decreasing portion of the profit pie.

METRICS

While pay-for-performance can be measured on various levels such as individual performance, team performance, corporate performance, business unit performance, etc., it can also be delivered through various compensation vehicles, such as base salary increases, annual incentives, and/or long-term incentives.

How companies effectively reward top performance, while retaining the remaining employee population, has historically been a tricky proposition. However, some of the top performing companies in the U.S. have relied upon the following vehicles to reinforce a dramatic pay-for-performance program:

- Additional base salary increases
- Annual incentives
- Long-term incentives.

ADDITIONAL BASE SALARY INCREASES

While most companies have decreased all employee annual salary increases to approximately 3–4 percent, top companies that have formalized paying for top performance carve out additional salary increases (*e.g.*, an additional 3–10 percent) for star performance. The wide range of salary increases allow managers to have flexibility in rewarding and further motivating star performance. In fact, many top companies institute a compensation philosophy that reward top performers by paying base salaries comparable to the 75th to 90th percentiles of market competitive data, while average performers are compensated at or below the 50th percentile.

Best Practice

Rewarding top performers

Company name:	**ABC Corporation**
Problem faced by company:	ABC Corporation was in a habit of paying all employees across the board increases. During the weak economy and tightened budgets, the company found itself with reduced salary increase budgets and inequities. Some divisions with larger budgets paid out increases while other smaller divisions instituted salary freezes. The company had no formal salary administration plan or merit program in place to ensure that increases were given not on a divisional budget basis but on a performance basis.
Compensation solutions:	Especially during a down market, companies should take care to ensure that limited payroll dollars are distributed in a way to reward top performers. A performance evaluation plan was set into place to objectively measure each individual's performance throughout the company's fiscal year. Once the performance evaluations were administered, increases were provided to qualified employees directly tied to performance. The company can reward high achievers with a greater increase than average performers.
Benefit to company:	By implementing a performance based merit plan, ABC Corporation was able to target its limited payroll merit budget more effectively and increase production among its employees.

Annual Incentives

Annual incentives are one of the most commonly utilized pay-for-performance methods. While the actual design and delivery of annual incentives are as varying as the business strategies they support, there are some recurring concepts that appear to reinforce sound "reward the best, push the rest" practices.

Providing additional pay for additional contributions is a key concept. In short, if the payout line were plotted on a graph in relation to performance, the best companies tend to draw out an exponential curve as opposed to a straight line. For example, the greater the performance achieved above a targeted goal, the exponentially greater the payout. Therefore, top performers are motivated beyond just a one-to-one incremental payout relationship performance. Consequently, below average performers are equally penalized for not accomplishing established goals.

Top companies are increasingly providing annual incentive targets above market midpoints. For example, leading edge companies' compensation philosophies are increasingly focusing on annual and long-term incentive opportunities whereby base salaries are targeted at 85–90 percent of market midpoint, and annual incentive opportunities are targeted at 110–120 percent of market midpoint.

Top companies are also increasingly mastering the difficult task of aligning goal setting with corporate objectives. In fact, some companies are starting to bake into their performance plans and payout systems how employees perform given changing business conditions: a very difficult economy, adverse legislative impacts, or even windfall events that were unaccounted for during the goal setting process.

Long-Term Incentives

Long-term incentives can provide significant wealth creation opportunity for top performers, and companies have historically recognized the tremendous attractive, retentive, and motivational impacts of these awards. In fact, long-term incentives such as stock options, restricted stock, and phantom stock have historically been a preferred method for employers to attract the best talent possible. Beyond long-term incentive awards upon hire, top companies also grant varying amounts of long-term awards as a means to reward star performance, retain star performance, and send a message to all others that there is significant wealth creation opportunities if given performance levels are achieved.

Best Practice

Companies such as Microsoft have already turned to restricted stock and performance shares as a key vehicle outside of stock options to reward star performers.

No matter what the method for delivery, rewarding the best while pushing the rest sends three very effective messages to all employees, including:

1. Employees can and will be rewarded for significant contributions to the company.
2. The company will hold employees accountable for their collective and individual performances.

3. The company will share rewards equal to returns provided to shareholders, emphasizing that employees are just as important as the constituents they serve.

In fact, research indicates that additional compensation, or lack thereof, as it relates to individual performance sends a stronger message to the employee than anything else ever communicated. Organizations have slowly come to realize that, to be competitive in an up or down market, they can't afford ***not*** to reward the best. Without an appropriate rewards system, the best, brightest, and most ambitious people will feel undervalued and ultimately leave for greener pastures—or, equally as bad, stay at their company and slip into mediocrity.

POTENTIAL PITFALLS

The "reward the best, push the rest" strategy can be very effective in creating a successful organization. The strategy, however, is not without potential trouble spots. The implementation of this type of system requires the design personnel to be cognizant of issues that could reduce the effectiveness of its use.

METRICS

Measurement is perhaps the most important factor in the success of any rewards system. Any system must be objective in order to be effective. As in prior discussions about variable pay, measurements must be carefully selected to insure the proper behavior. The measurement system must be well communicated.

The rewards system must be objective in design. Performance metrics should be well established prior to related pay increases, bonuses, or other rewards. The entrance of subjectivity into the rewards criteria creates a sense of unfairness among the employees. Subjectivity can also create a culture of "yes" people as everyone attempts to earn favor. Not only do other employees become resentful of "pet" employees, but the culture of creativity and challenging of ideas can disappear.

Discussion among employees about how much their peers are receiving should be monitored. Comparisons will occur despite attempts by the management to quell such conversation. Talk about

relative rewards can be both good and bad. In some cases, it may be a motivation factor for those who are not receiving as much. At other times, this discussion can work to demoralize and segregate employees. A wider gap between the "haves" and the "have nots" requires more discretion on the part of the "haves."

This gap between haves and have-nots can also lead to other problems inside the company. Teamwork may deteriorate as a result of jealousy. Internal conflict must be monitored to prevent major issues due to cultural dysfunction.

Another potential issue in using this system is the problem of star or near-star employees falling through the cracks. Not all people are motivated in the same manner, so some top employees may not be rewarded in ways that actually motivate them. Also, some employees may fall victim to political or personal dislikes.

Rewarding only the best may also cause another pitfall. The rest of the company may sink completely into the morass of mediocrity as a result of apathy among the tier of workers who are not being rewarded. This situation is almost as dangerous as losing star performers because stars lose their support systems.

The economy itself is an issue. In a down economy, rewarding star performers may seem more difficult. However, continuing to provide a tangible reward for star performers is critical as they provide much of the competitive advantage.

Finally, if the company does not follow through with promised rewards, employees are likely to find a new employer.

WHAT ABOUT "RANK AND YANK"?

"Rank and yank" is the nickname for a process in which companies rank employees from best to worst and use the rankings to establish pay and employment status. Typically, the bottom group in this process is told to pack their things. Reallocation of compensatory packages may occur among those who remain.

THE PROBLEMS WITH FORCED RANKING

Forced ranking is the performance management process where everyone in a company, division, or department is ranked from best to worst in an effort to determine how to allocate pay and/or the implementation of a reduction of force. It is easy to rationalize forced ranking when the economy is down, when your industry is