Compensation & Benefits Review

Ten Common Compensation Mistakes

FRED E. WHITTLESEY
Principal
Compensation and Performance Management, Inc.

CAROL L. MAURER
Principal
Compensation and Performance Management, Inc.

"These ten mistakes and scores of others can be prevented by following one principle: Make compensation decisions on the same basis as other business decisions."

Ten Common Compensation Mistakes

FRED E. WHITTLESEY
Principal
Compensation and Performance Management, Inc.

CAROL L. MAURER
Principal
Compensation and Performance Management, Inc.

Organizations that neglect compensation management often find themselves facing significant problems that surface long after costly, high-profile programs have been implemented. These problems frequently are rooted in the chaos surrounding start-up operations or major reorganizations, when compensation plans receive relatively little attention in light of more pressing issues. Today's leaner staffing levels also contribute to many companies' inability to foresee potential compensation problems.

Small and midsize organizations have always faced this problem. They are usually governed by a handful of executives with a variety of skills and often structured around these individuals' talents. Until a company reaches significant size, the management team rarely includes a human resource professional. Consequently, planning and developing compensation programs receive less formal attention than other management issues. This operations-oriented focus can lead to incentive programs that don't work, inequitable salary arrangements, and compensation plans that contradict one another or the company's business objectives.

These issues are not limited to small companies. Restructuring or other major changes can cause big firms to suffer comparably. Many large companies have embraced the traditionally "middle market" characteristics of lean staffing, limited resources, fast growth, and continual entry into new markets or product areas. These challenges add to the likelihood of an organization making compensation design decisions that have a negative impact.

While there is no single magical solution for all compensation problems, some forethought regarding plan design can alleviate many headaches down the road. Ten common mistakes are the source of many compensation problems. Each can have a considerable financial and operational impact on the company, and all can be avoided by adhering to some simple principles of effective compensation design and administration.

1. PERMANENT FORMULAS

Compensation arrangements based on formulas, such as senior executives receiving annual bonuses equal to 1% of profits or sales

representatives earning straight 5% commission, regularly result in long-run payouts that exceed the value of the employee's contributions. These plans are often installed when the company is small and any results achieved are so greatly appreciated that the proportion of the results paid out seems irrelevant. In larger firms, this type of plan is frequently used to compensate salespeople or executives in entrepreneurial divisions.

But unexpectedly large individual compensation payments are usually the result of uncapped formulas in nonexpiring agreements and are almost always a cause of great concern. These fixed formula plans can generate substantial costs as a company or unit grows and compensation levels increase proportionately. As an unchecked liability, these plans usurp cash flow and create barriers to negotiating an equity offering or company sale. They also may fuel unreasonable employee expectations, even if the company is already paying above-market rates. An employee who is given incentives during a start-up or turnaround period may anticipate high payouts based on company forecasts, while management anticipates only minimal awards. If compensation arrangements are defined for a single measurement period, with a review of the plan prior to its continuation for additional periods, many of these problems can be avoided. Doing so will help manage employee expectations, control costs, and limit the likelihood of disagreement or legal action brought on by open-ended arrangements.

2. Copycat Plans

Some managers become aware of an incentive plan through a friend or competitor, or by reading about one in an article. The plan purportedly has achieved favorable results and sounds as if it may remedy a current problem. The manager implements the plan or a facsimile without much further analysis. Adopting an existing compensation plan is not inherently a bad idea, but the plan may not meet the company's needs. The greatest risk in using a plan designed for another situation is misalignment with the current business strategy or the company's operational needs. If the company is focused on long-term results, a plan rewarding increased sales volume or short-term profitability is unlikely to support these goals.

This mistake occurs most regularly in companies that lack the financial ability or inclination to hire professionals or consultants to develop an incentive plan specific to the company's unique needs. It is not unusual to find another company's plan documents adopted verbatim; many entrepreneurs see this as a clever approach to avoid reinventing the wheel. But companies should undertake a careful study of the plan's rewarded behaviors and financial impact before implementing *any* incentive plan.

3. Failure to Analyze Financial Impact

Many incentive plans are put in place without ever fully analyzing their impact on earnings and cash flow. Without assessing the possible total compensation levels under a variety of scenarios, management and the board of directors won't know if the plan will achieve its financial goals and if it will appropriately compensate employees. For example, one organization discovered long after implementation that its incentive formula resulted in payments to executives of 140% of company profits—a plan that would quickly dissolve both the company and its future employment possibilities. Another corporation inadvertently structured its incentive plan to require growth rates and profitability levels of twice the industry average in order to achieve minimum payout levels, resulting in a plan that had no credibility with participants.

This type of mistake often leads to crises at the end of the performance period—after the plan has generated a much higher or lower payout than expected and attempts to remedy the situation are thwarted by written agreements or financial limitations. Projecting aggregate anticipated results and costs of an incentive program under the current operating plan and various alternative scenarios is essential to understanding the impact it can have. This is particularly true with equity-based plans (such as stock options) that require special accounting and tax treatment.

4. Tax-Driven Plans

Compensation plan design decisions frequently are based solely on the tax consequences for the employee and/or the corporation. IRS-qualified incentive stock option (ISO) plans, corporate-owned life insurance policies, and nonqualified deferred compensation programs are all used to provide tax-advantageous pay, but they may not be the most financially efficient method to achieve the desired behaviors or results. A comprehensive analysis may indicate that the perceived benefits are outweighed by negative cash flow or accounting charges.

For example, ISOs are considered tax-favored equity-based incentive plans but in fact are quite costly in terms of relinquished company tax deductions and associated cash flow impact. Companies often are surprised to find that nonqualified stock options (NSOs) offer a greater benefit at a lower cost. Fortunately, few companies have continued using ISOs because the current tax rate structure emphasizes these differences. But the total financial and business implications of all vehicles, encompassing far more than just the immediate tax advantages, should be clear before any compensation program choice is made. A complete analysis of the behavior to be rewarded and of all the vehicles available to achieve this reward will help the company identify the most efficient method of compensation.

5. Recruiting Fixation

One of the easiest issues to spot during a compensation program review is a few notably high base salaries or "special deals." Individuals receive special consideration because they possess critical talents, have a persuasive or demanding manner, or have been identified as people the company must have for some other reason. Individualized compensation arrangements rarely go unnoticed by other employees, despite the company's best efforts at secrecy, and usually cause some rancor within the employee group. If the person doesn't live up to the reputation that earned the special consideration, the company must live not only with the high salary cost (and other compensation that leverages off salary), but also with the potentially demoralizing lack of internal equity.

Managers should try to move away from thinking only "How much must we pay for this person?" when they identify a strong candidate for a position, but also focus on "How much must we pay to staff this position?" Only when both answers come out relatively the same have the right candidate and pay package been identified. By setting up compensation guidelines based on current market norms before recruiting for a position, employers can avoid this mistake.

6. Equality-Based Plans

It is usually easier for a small company to install compensation plans that cover all employees equally, because there can be a great savings in administrative time and expense. By using universal plans, managers can avoid the difficulties of differentiation—$50,000 life insurance coverage, $500 Christmas bonuses, or 100 stock options can be given to every employee regardless of performance, responsibility, or salary level. In these instances, it's usually felt that lower-level employees benefit from such egalitarian treatment and that higher-level employees will understand the rationale for using a simplified approach.

But as a company grows, universal plans inevitably overcompensate employees at lower levels, creating heightened expectations, while they undercompensate employees at higher levels, leading to morale problems or necessitating special arrangements. A typical company with a large percentage of lower-level employees will have higher human resource costs than necessary and may create resentment because these plans undermine efforts to use compensation as a tool to manage performance. Workers who feel they are greater contributors don't appreciate "share-the wealth" concepts and are more likely to seek an employer with a compensation program that will recognize their special talents.

Now, more than ever, the marketplace supports pay-for-performance—compensating em-

ployees for the results they achieve and eliminating entitlement programs that ignore individual performance. Differentiating between employees allows the company to reward better performers and communicate the results of poor performance to lesser employees.

7. Plans Preceding Systems

Many companies forget to inventory their existing performance measurement systems before implementing incentive schemes. And what can't be measured is difficult to reward. This is an easily identifiable problem in most organizations, but usually only after the problem has run its course. Symptoms include disputes over performance levels, after-the-fact adjustments to incentive payout calculations, and incentive plans that drive such fundamental decisions as information systems investment or accounting method selection. This mistake causes time-consuming disputes, increased workloads for support departments as they attempt to arbitrate, and poor business decisions resulting from attempts to quiet the situation.

Most organizations benefit from deferring the design and implementation of incentive programs until all necessary data-gathering and measurement processes are in place. Although the company won't be able to quickly reap the benefits of incentive compensation, slowing down the process until underlying systems are functioning properly leads to better plan results.

8. Lack of Formal Controls

Some of the frequently cited advantages of entrepreneurial working environments are the absence of bureaucracy and greater autonomy in decision making. These freedoms may lead to inconsistent regulation of pay levels and incentive arrangements because control has been decentralized.

Companies with decentralized compensation control are likely to have higher human resource costs and more internal equity problems. Even though they may be responsible for managing costs, most managers strive to provide their employees with the highest possible compensation because they don't suffer directly from the increased cost and they benefit from being the "nice guys." In addition, when individual managers make policy decisions regarding subordinate compensation, every unit is likely to receive dissimilar pay for similar tasks.

The spirit of decentralization, entrepreneurship, and flexibility need not be compromised by centralized administration and control. By identifying one person as responsible for supplying managers with simple compensation structures and guidelines, the company can easily prevent excessive compensation costs and assure some internal equity.

9. Focus on a Single Plan

Few companies perform timely, systematic reviews of *all* compensation programs. Most examine base salaries for selected positions when turnover or employee complaints dictate, and review related bonus opportunities, benefit programs, or equity-based incentive plans separately. As a result, the organization never gets a complete picture of total compensation program competitiveness. The company may adjust a specific pay level or program that seems below the competitive average without considering the overall value and mix of all programs offered. It may position its salaries, benefits, or incentive programs at varying levels above or below market norms based on business and compensation strategies, cash flow requirements, or employee demographics. Evaluating a single compensation element without a comprehensive total compensation analysis may lead a company to believe it is out of sync with the market when it is not.

Changing compensation programs based on a single analysis can lead to recruiting difficulties, excessive turnover, higher human resource costs, inconsistency with compensation philosophy, and excessive pay for certain employee groups. As incentive compensation becomes more common for the broader employee population, integrated program analysis becomes critical to good company performance.

10. People Problems and Fear of Employee Reactions

Compensation issues raised by a vocal individual or group are frequently deemed "people problems" rather than financial or operation issues. In an effort to alleviate pressure quickly, managers may ignore the underlying problem and make decisions regarding plan operation that fall outside normal administrative processes. These deviations may include lowering performance targets/thresholds, adjusting pay arrangements, or overriding plan provisions. In other cases, companies dissatisfied with their current compensation programs often hesitate to make improvements because they fear employee reaction.

Compensation decisions made solely to pacify employees inevitably produce higher operating costs and create an environment that rewards complaints rather than performance. When special treatment results from bullying, other employees have a model for demanding special accommodation, resulting in ineffective, inefficient, costly, and burdensome compensation programs. A company that has invested time and effort in designing an equitable, competitive program must be willing to adhere to it, or there really is no program at all. Developing administrative guidelines during plan implementation will simplify problem-solving and ensure thoughtful and consistent decisions. When compensation changes are dictated by business needs, they should be implemented with the clear communication and resolve given the new marketing tactic or financing strategy, and without fear of employee reaction.

A Strategy for Avoiding Mistakes

These 10 mistakes and scores of others can be prevented by following one principle: make compensation decisions on the same basis as other business decisions. Employees are, in strict business terms, assets that create revenue *and* liabilities that create expense. Like any other resource, an investment must produce a positive return over a specified period of time. Though the return on employee investment is more difficult to measure than it is for other assets, managers shouldn't yield to nonbusiness considerations in making decisions. If a company is not willing or able to implement formal, structured compensation programs, it will still benefit from a consistent set of decision principles that:

- links with the company's strategic and financial objectives,
- states the company's intended competitive position,
- stresses the importance of internal equity and consistency,
- communicates the logic behind implementing each plan, and
- outlines methods for reviewing or updating programs.

This strategy not only will produce greater returns but, over time, also will ensure fewer of the unpleasant human resource problems that everyone strives to avoid.

Fred E. Whittlesey and Carol L. Maurer are the founding principals of Compensation and Performance Management, Inc. (CPM), a human resources management consulting firm with offices in San Francisco and Laguna Niguel, Calif. Prior to founding CPM, they comprised the management group responsible for KPMG Peat Marwick's western region compensation consulting unit. Whittlesey is a founding member of the National Association of Stock Plan Professionals and a regular speaker for The Executive Committee. He holds a masters in business administration from UCLA. Maurer has worked for the past several years as a strategic and financial consultant. She holds a degree in applied mathematics from the University of California, Berkeley, and is currently a Dean's Fellow in the masters in business administration program at the University of Southern California.