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With the economic pressures organizations are facing, there are a host of different approaches for companies to correlate performance with pay. Depending on your organization's business objectives, unit objectives and individual objectives, this approach could look completely different for you than it does for the company next door. One constant remains the same across all companies and competitors- the criticality of your talent. Compensation, though just a component of employee engagement and retention, is a critical one to continually evaluate and fine-tune. By doing so, you will ensure you are rewarding appropriately to keep your organization and your employees motivated and moving ahead in the right direction.

TalentQuest engaged our partner John Markson at MarksonHRC to share his expertise around this hot topic. John has over 25 years of experience consulting on executive and broad-based compensation and benefit issues and has consulted with some of the world's largest companies on plan design, administration and implementation. Below, John shares his insights on how the metrics executives are measured upon are shifting and how many organizations are retaining their key talent by restructuring their rewards.

"What Kind of Performance Are You Paying For?"

Evaluating Executive Compensation and Equity

-John Markson

President, Markson HRC

The resilient recession together with large bonuses paid out by soon-to-be bankrupt Wall Street banks has spurred lively discussion around the topic of executive compensation. In particular, it has forced a wide-spread reassessment and scrutiny of what, until now, has seemed a business truism along the lines of buy low and sell high: "paying for performance". This reassessment is taking place at all levels but particularly in compensation for key executives.

In addition to keeping us up at night, poor business conditions can inspire us to rethink common practices and challenge prevailing wisdom. Pay systems should be closely examined to ensure that they are rewarding actual value creation and not merely the financial results that are often independent of performance.

Let's take a look at an actual example to bring this concept to life.

Recently, I attended an executive team meeting of a large, publicly traded construction company where they discussed 2008 fiscal year bonuses and 2009 goals in a business environment about as gloomy as any had seen. No one was buying houses and commercial development projects were limited to relatively minor build-outs. None of the stock options granted during the prior five years were even within sniffing distance of being exercisable.

Until now, the company had a compensation program they saw as best practice. Bonuses at the top were paid out based on two quantifiable goals: revenue and EBITDA growth. These goals cascaded down through the organization in various forms so that there was a strong line-of-site to company-wide goals from the administrative assistants on up. In order to provide to provide alignment with shareholder objectives, stock options were granted down to the manager level and were as much as 50% of anticipated compensation at the C-level.

Now the executive team was faced with the prospect of paying out (and receiving!) zero bonuses for 2008. Stock option recipients began to see their options as something akin to German deutschmarks in the 1920s.

In one sense the management team recognized that the system had worked. Performance had been poor, so bonuses should also be poor, right? Not quite. Results certainly were poor but performance by many measures was outstanding. This was not an exercise in semantics. There was serious concern about retention of some of their high performing talent - particularly when the job market picked up.

Revenue had not grown and EBIDTA had sunk but performance in both areas was among the best in the industry. The sales force seemed to extract every dollar the market was offering, the financial staff had made sure their were no surprises for wall street and had suggested and implemented several key cost-saving initiatives around the supply chain and human resources had helped reduce headcount by 20% and somehow still maintain a sense of morale. The stock price was in the tank but its decrease was less than any other major public builder.

For this company at least, there was a significant difference between results, as dictated largely by the market, and performance. This gap has always existed but it is being highlighted under the prevailing economic downturn.

Absolute vs. Relative Performance

While by no means a trend, based on my discussions with compensation professionals and corporate management and boards, companies are responding to this gap is by reassessing their measure of "results" to better isolate measures of performance. In determining compensation structures, companies are reconsidering their definition of performance and moving away from numerical standards such as sales, revenue growth, margins and expense reductions towards *more nuanced approaches that measure performance more directly..* This approach places more emphasis on relative measures and specific business initiatives as more accurate indicators of value creation. I have seen many companies incorporating these 'revised' performance measures, including new clients added, relative growth in revenue, relative growth in earnings, specific operational efficiencies implemented, client and employee retention, and market share. Some of these cannot immediately be measured with a financial index but are extremely valuable to organizational sustainability and long-term growth.

Considering everyone in your competitive space is struggling to some degree to stay afloat, challenge your executives with the key questions that encourage value creation behaviors. e.g., "What are we going to differently/better than our competitors? What cost-cutting measures have you introduced? How are you positioning yourself to grow? To gain market share? To remain in or attain the top tier?" These are going to be the differentiators that distinguish both individual and organizational performance.

However, the caveat to this approach, for public companies in particular, is that shareholders may resent management receiving large bonuses when the company performs poorly in absolute terms. You should evaluate your specific company position (public, private, etc.) and your stakeholders before significantly shifting your compensation structure.

For senior management, one recommended approach is to use a measure of *absolute performance as well as relative performance.* This combination of relative and absolute measures is more comprehensive in terms of overall organizational impact and value. For example a CEO bonus payout might be based on a matrix like the following with 50% attributable to relative revenue and 50% to EBITDA.

Bonus paid as a Percentage of Target

		Relative Increase in Revenue/EBIDTA Against Competitive Community				
		Top 10%	10%-40%	40% - 60%	60%-75%	Bottom 25%
Absolute Change in Revenue/ EBIDTA	Greater than 10%	200%	175%	150%	100%	50%
	5% to 10%	150%	125%	100%	75%	25%
	-2% to +2%	100%	75%	50%	50%	0%
	-2% to -10%	75%	50%	25%	25%	0%
	Less than -10%	50%	25%	0%	0%	0%

A company that experienced 0% increase in revenue and 0% increase in EBIDTA but performed in the top 10% of the competitive community in revenue growth and the median in EBIDTA growth would payout a cash bonus of 75% of target (50% * 1.0 + 50% * 0.5) = 75%.

The point of this exercise is to promote performance and the behaviors that create success rather than the success (or failure) itself which can result from factors having nothing to do with individual performance.

Rewarding Employees with Equity

Unfortunately, for many smaller companies, the above illustration is a theoretical exercise only. They simply do not have the cash to pay out significant bonuses even if performance, relative or otherwise has been outstanding. These companies are looking for any means possible to retain their top performing talent, regardless of short-term results, so that when better times return they still have a business.

This lack of cash has forced smaller, closely held companies to be more creative in their employee recognition approaches and begin using significant equity grants for the first time- albeit in different ways than public companies. Until recently, many private companies would rarely grant equity compensation below the top one or two executives. They preferred to keep equity closely held and use pure cash bonuses to reward results/performance. With cash short, equity now looks like the best compensation game in town.

The big challenge for private firms is that as they do not have a public market for their stock, and stock price is usually determined based on a formula or valuation. But, no matter what the valuation is, the company is the only market maker and must ensure that it has cash on hand to purchase equity grants back from their employees. It could be a financial disaster if valuations showed large gains but cash flow was poor at the time employees decided to sell their stock.

Private companies can avoid this dilemma by adding performance triggers on the payout. Examples of triggers include:

§ Stock can only be sold when a transaction occurs

§ Options do not vest until revenue reaches a specific $ threshold

§ Options and stock grants do not vest until net earnings reach a specific $ threshold.

Properly structured equity grants are an excellent, proven way of retaining your top talent without depleting scarce cash. Smaller companies that have never thought of using equity compensation should reconsider the approach making sure that payouts are also based on value creation with appropriate guards against insufficient cash. Adding the appropriate trigger condition to a stock sale will ensure that your company has sufficient cash to buy the stock.

Every company is facing some degree of competitive and economic pressure, and employee engagement is absolutely critical to keep your organization afloat. Creative compensation approaches will reflect your commitment to respond to changing market and economic conditions and to reward your employees appropriately. The ideas mentioned are just the tip of the iceberg- I encourage you to routinely evaluate your compensation structure and customize each component to the unique needs and demands of your business and your executive team.

For specific questions or comments regarding this article or the broader executive compensation arena, please contact me anytime at jamarkson@marksonhrc.com

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TQ SPOTLIGHT...

Policy Capturing:

Is Your Compensation System Aligned with Your Desired Outcomes?

We have all seen compensation and performance management systems that were designed with the best possible intentions and yet they somehow failed to achieve the desired results during implementation. In fact, much has been written about the potentially de-motivating effects of such systems. So an interesting question becomes, "How can we *diagnose* whether the new system achieved the desired results and what, if any, modifications are necessary to ensure the intended organizational outcomes?"

This issue will be especially critical as organizations move toward systems that have more subjective components of determining total compensation in comparison to previous long-standing methods that are largely based on a set of fairly hard objectives, financial measures and outcomes.

As Mr. Markson noted, given today's current economic conditions, a greater emphasis may have to be placed on developing pay-for-performance systems that take into account relative aspects of performance that are not readily tied to bottom-line, financial outcomes (e.g., clients added, relative growth in revenue as compared to competitors, relative growth in earnings, operational efficiencies and cost reductions introduced, etc.). Such systems are necessary to ensure that key talent is not lost during relatively flat times in a company's financial performance in order to sustain the longer-term viability of the organization.

The old adage "you get what you pay for" is tried and true. However, a more important notion for organizations that undertake comprehensive total compensation redesign efforts, especially ones that incorporate more subjective compensable factors, is to ask the question, "Are we paying for what we have communicated we are paying for?" Perhaps even more important is to ask the question, "Are we, in fact, providing incentives to motivate our employees to undertake the desired behaviors that our new process is designed to achieve?"

There are several common qualitative and quantitative techniques that can be used to shed light on the answer to these questions (e.g., focus groups, attitude surveys, attrition

analyses, etc.). However, a very powerful method that especially lends itself to examining the effectiveness of new compensation systems, and which has received relatively less attention in most organizations, is a technique referred to as "policy capturing".

Policy capturing is a quantitative technique that allows for the examination of how decision makers *weigh the relative importance* of a variety of factors when making overall decisions. It has been used to assess implicit assumptions policy makers utilize when arriving at conclusions in a variety of decision making activities including strategic planning, investment planning, acquisition analyses and proposal evaluation.

In compensation, policy capturing is often used to determine the relative weights groups of decision makers place on a variety of factors the organization has determined are important to making sound business decisions (e.g., compensable factors) in job evaluation systems (i.e., setting base pay rates), promotion board decisions, merit pay decisions, and setting bonus allocations in equity ownership situations, etc. The following example is provided to illustrate the technique and its value in ensuring that the sound decisions made actually reflect the original design intent and organizational objectives.

In this case, a large regional professional services firm with several hundred equity ownership partners and over five hundred billable associate staff members had recently decided to shift its business model from that of a loose collection of partners and offices with individualized practices "sharing overhead" to a more integrated business model centered on common practices across offices. The firm also wanted to ensure that billable work was being pushed down to the lowest possible level to maximize profits by minimizing under utilization of junior staff. Additionally, the firm wanted to expand opportunities for selling services across practice areas to provide more comprehensive solution to clients and increase revenues.

In order to accomplish these objectives, the firm implemented a new strategy and structure, invested in new information sharing technology and upgraded its client service management system. A large-scale change management, communications and training program was implemented to ensure the success of the initiative.

Practice groups were defined, new practice group leaders were identified and all equity owners were trained in leadership and staff development/mentoring to help drive the initiative. Additionally, other equity owners and junior associates were nominally assigned to the new practice groups and all billable staff members were trained in business development and in identifying cross-practice group selling opportunities.

Finally, communications were provided indicating that equity owner bonus allocations would be determined based on an examination of personal collections (hours billed) and increases in staff hours billed and business development/cross-selling activities. Further, clear communications were provided that a much greater emphasis would be placed on the new, broader organizational outcome indices as opposed to the more traditional focus on personal collections in the past.

The overall effort was determined to be very successful at the end of the first year based on firm-wide financial indices. Accordingly, when the firm compensation committee met to set equity owner bonus allocations, they were given data based on a variety of performance indices by practice groups which included personal equity owner collections and *increases* in staff collections, utilization rates and the outcomes of business development and cross-group selling activities. The compensation committee held initial meetings to develop bonus allocation recommendations to the management committee as was the traditional practice.

Prior to the final submission of these recommendations, policy capturing was employed to assess the relative weights the committee members placed on the new compensable factors. Anecdotal evidence indicated that the members of the compensation committee were confident they had placed a *significant* emphasis on the new compensable factors in differentiating equity owner bonuses.

However, the results of the policy capturing indicated that the committee had placed an inordinate amount of emphasis on personal collections (76% of the differences in bonuses)

and relatively less emphasis on staff utilization and cross group selling activities (10% and 9% respectively). The remaining 5% of differences were attributable to "other factors." Thus they had implicitly followed traditional mental models and placed *way* too much emphasis on personal collections. This was especially interesting as other analyses indicated that a substantial proportion of the increases in financial indices could be attributed to better staff utilization/leverage and new cross-group business development activities rather than traditional metrics associated with individual equity owner dollar collections.

Accordingly, the compensation committee reconvened and adjusted the bonus allocations with a much greater focus on the new, non-traditional compensable factors. This was an especially critical outcome because as a majority of equity owners agreed, had the original recommendations been followed, the success of the new strategy could have been undermined. This is because we all know that people are 'quick to determine what they are being paid for and will readily adjust their behaviors to maximize personal outcomes in most situations.' Hence, regardless of the success of the new strategy from an organizational perspective, it could have been viewed as "unfair" by many at an individual level.

As noted above, policy capturing can also be used to assess the extent to which decision makers weigh alternative compensable factors when making merit pay increases (e.g., how much emphasis do managers across large organization place on the achievement of objectives vs. increases in individual competency, etc.?) as well as in other compensation and performance management decision processes. Sometimes, the results indicate the need for substantial changes in the practice of compensation or performance management *administration* to ensure it meets the organization's original design objectives, as in the example provide above; and other times, the results of policy capturing analyses simply confirm that strategies are in fact being implemented in the manner in which they were designed.

In conclusion, a major advantage of policy capturing is that it is not prescriptive or evaluative of individual decision makers. Rather, it is simply a descriptive technique that can be used to quantify the relative weights decision makers place on a variety of factors when coming to conclusions. Hence, it is in effect a mirror that can be held up to the organization to shed light on whether HR processes are creating lasting changes in individual behaviors and achieving organizational outcomes. Accordingly, it can be very useful in testing implicit assumptions used in decision making and in ensuring that the *practice* of implementing new compensation systems is in fact is in alignment with the organization's original design objectives.

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