

# Session 4

## Variable Pay

# Reasons to Consider Variable Pay

- Cost is variable not fixed
- Variable rewards tend to have higher motivation than changes to base salary
- Ability to tie rewards to specific business outcomes
- Provide a piece of the action
- External competitiveness

# Types of Variable Pay Plans

- Individual based plans
  - Measured output (i.e. piece work)
  - Performance vs. predetermined objectives
  - Sales commissions
  - Skill or competency based
  - Suggestion award / recognition
- Group based plans
  - Profit sharing (financial based)
  - Gain sharing (operational based)
  - Goal sharing (multi factor based)

*Plans can combine group and individual measures*

# Questions to Ask When Considering Variable Pay

- What is critical for the organization to be successful?
  - Balanced scorecard handout
- What key behaviors or are needed to fulfill these success factors?
- Who can carryout these key behaviors (line of sight)?
- How does the organization best encourage and reinforce these actions?
- Is variable pay a competitive component of total compensation?

# Line of Sight

- One of the most important concepts in variable pay design is “line of sight”
- Defined as the plan participants ability to effect the measures of the incentive plan
  - Therefore, there are two considerations to line of sight – including the correct participants developing the correct measures
  - It may not be possible for participants to fully control the achievement of results, but they must be able to influence them
- Line of sight exercise

# Variable Pay

## Design Considerations

- Funding mechanism for the incentive - Incremental return to finance the incentive
- Payout mechanism for the incentive – What are we paying for!
- Mix of base pay and incentive pay
- Participants – All or a select few
- Measures – Individual vs. team
- Frequency of measurement and payout opportunity
- External market practices – is variable pay the norm or exception
- Program effectiveness evaluation

# Management Incentive Plan Design Example

- Type of Plan: Performance based on objectives
- Participants: Managers and above
- Funding measure: Profitability of company

Performance Level	Profitability Results Against Budget	Funding Level
Maximum	150%	200%
Target	100%	100%
Threshold	50%	25%
Below Threshold	<50%	0%

- Payout measures: increase in sales (25%), customer satisfaction (25%), individual objectives (50%)
- Targets by job level: VPs (20% of salary), Directors (15% of salary), Managers (10% of salary)
- Payout: Annual

# Piecework Incentive Plan

- Type of Plan: Piecework
- Participants: Pallet Builders
- Important Info: Minimum wage: \$7.25, competitive market: \$9.00 / hr, expected productivity: 40 pallets / hr
- Basic piece rate calculation:  $900 / 40 = \$0.225 / \text{pallet}$
- To earn minimum wage:  $7.25 / 0.225 = 32$  pallets – does this make sense?
- Our best pallet builders make 60 pallets / hour, earning \$13.50 / hr – does this make sense?
- Other questions:
  - What is our profit per pallet?
  - Quality concerns
  - Competition practices

# Inside Sales Commission Plan Development Exercise

- You have been asked to develop an incentive plan for a department of inside sales representatives. Competitive total cash for the job is \$15 / hr. The sales rep cannot control price. An average sales rep would sell an average of \$5,000 / day.
- Questions:
  1. What would you recommend as the mix between base and incentive?
  2. What measure would you select to base the incentive?
  3. What would be the commission rate (% of revenue) paid to the sales rep?
    - You will need to determine the incentive paid based on the mix, and divide by the sales quota
  4. Based on your commission rate, what would be earned per hour at if the rep sold \$7,500 per day?
  5. Would you want to add a maximum above which incentive would not be paid?
  6. How frequently would you want to measure and pay the incentive?
  7. Are there other considerations you need to include in the plan?

# Incentive Plan Audit Elements

- Link to the business plan – key drivers
- Measures within participants control
- Participant understanding
- Correlated with other measures of performance
- Administrative procedures
- Plan documentation

# Exec Pay Goals

- Tight tie to strategic plan
- Quantifiable and tied to business results
- Competitive in the relevant industry
- Short, medium, and long-term focused
- Retention of executives (if performing)
- Ability to create and retain wealth – taxation issues
- Aligned with governmental regulations

# Exec Pay Component Mix

- There are three components of pay: short-term (salary), annual incentives, and long-term pay (3-5 years in time horizon)
- The component pay mix is determined by many variables
  - Company lifecycle
  - Industry / competition
  - Size of the company
  - Executive level
  - Company strategy and culture
- Structure of the mix is a major influence on executive behavior and corporate culture
- Other influences
  - Governmental legislation
  - Board of Directors / Capital Partners

# Short-Term Fixed Pay - Salary

- Foundation of most reward systems
- Provided when other components may not be employed in the reward system
- Other components often calculated as % of salary
- Cannot pay significantly under market and risk losing competitiveness
- External benchmarking critical
- Paying above market should be justified by above market performance
- Other factors sometimes in play

# Short-term Variable Pay - Bonus

- Best tool to pay for performance and link to business results – provides a “piece of the action”
- Helps communicate most important drivers for the business
- Short-term nature of the pay component allows adjustment as business conditions change
- However, incentive plans should not radically change year-to-year
- Designs should be customized for business lifecycle
  - Measurement selection and weights
  - Leverage factor
  - Thresholds and maximums
  - Absolute vs. relative measurement

# Long-Term Pay

- Encourages true ownership motivation and behavior
- Reward can take the form of equity or cash
- Stock option plans have term of 5 – 10 years
- Performance plans typically measured 3 – 5 years
- Retention an important goal of long-term pay
- Design considerations are many – same as in bonuses plus
  - Appropriate level for participation
  - Vesting period
  - New participant, termination, CIC provisions

# Indicators Your Reward System May Need Realignment

- Reward elements are managed separately, particularly if you have several elements to consider (i.e., multiple incentive plans, independent benefit decision-making processes, decentralized training and development programs, and so on)
- Reward programs are designed primarily based on competitive, industry, or “best” practices
- Reward programs send mixed messages
- Delivery of rewards is not tied to program intent (i.e., everyone in a division gets the same percent bonus payout even though the plan calls for dispersion based on performance)
- There is difficulty in attracting and retaining key talent
- Pay, benefits, and career programs are not well integrated, (i.e., there is no cohesive strategy)