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The 'Top Ten Criteria For Success' In Designing Equity And Variable Cash Compensation Programs

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1. A Successful Plan Is Aligned With Organizational Culture/Values

Culture and values must support a variable/
incentive framework: instilling a
“Sales Mentality”

Senior management must allow the
variable program to work

Should have “Pay By Example” at the top
of the organization



Every organization exhibits and demonstrates corporate values

In order to develop variable compensation and total reward strategies that “fit”, it is important that an analysis be performed to identify the culture/values exhibited in the organization.

The Five-Stage Corporate Values Assessment Model

Each of the four models that follow is represented as a continuum: Stages 1 and 5 are at the extremes --- they are identified by the key words and phrases.

Stages 2, 3 and 4 represent various combinations of the values identified in Stages 1 and 5.

*CURRENT
STATE*

*SUCCESS FACTORS &
BARRIERS TO SUCCESS*

*FUTURE
STATE*



Organizational Values Model

STAGE 1

STAGE 2

STAGE 3

STAGE 4

STAGE 5

| | |
|-----------------------------|-----------------------------|
| Hierarchical Structure----- | Horizontal Structure |
| Focus on Bottom Line----- | Focus on Mission/Customer |
| Control By Management----- | Employee Empowerment |
| Centralized----- | Decentralized |
| Compartmentalized----- | Integrated |
| Functional----- | Product/Service Line |
| Departmental Teams----- | Cross-Functional Teams |
| Narrow Job Definitions----- | Broad Job Definitions/Roles |
| Quality Control----- | Continuous Improvement |

Leadership Values Model

STAGE 1

STAGE 2

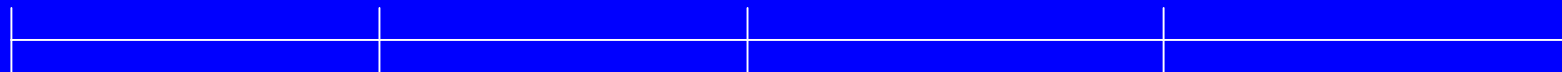
STAGE 3

STAGE 4

STAGE 5

Distrust-----Trust
Closed-----Open
Make Decisions-----Share Decisions
Judge-----Coach
Foster Independence-----Foster Teamwork
Take Credit-----Share Credit
Results Only-----Behavior & Results
Production-----Quality
Serve Boss-----Serve Customer
Fight Fires-----Light Fires (Inspire)

Performance Management Values Model



STAGE 1

STAGE 2

STAGE 3

STAGE 4

STAGE 5

| | |
|-----------------------------|---|
| Objective | Judgement-----Improvement |
| Time Orientation | Event/Past-----Cycle/Future |
| Rating | Results-----Results & Competencies |
| Rating Levels | Many-----Few |
| Summary Rating | Point Score-----Summary Statement |
| Standards | Job-Based-----Person/Customer-Based |
| Source of Input | Supervisor-----Multi-Rater |
| Improvement | Individual-----Individual & Processes |
| Responsibility | Supervisor-----Supervisor & Employee |
| Supervisor's Role | Judge-----Coach |
| Implementation | "Forms"-----Education/Training |
| Ownership | Human Resources-----Management/Employees |
| Performance Criteria | Not Specific/Disjointed-----Specific/ "Cascading" |

Reward Systems Values Model

STAGE 1

STAGE 2

STAGE 3

STAGE 4

STAGE 5

Reward Philosophy

Entitlement-----Achievement

Reward Delivery

Base Pay-----Base & Variable Pay

Plan Focus

Individual-----Individual & Team

Job Evaluation

Factor-Based-----Market-Based

Pay Structure

Salary Ranges-----Broad Bands

Salary Ranges

Many-----Fewer

Job Evaluation Resp.

Human Resources-----Line Management

Basis for Pay

Job Value-----Person's Value

Basis for Increase

Tenure-----Competency/Contribution

Evaluation

Supervisor-----Multi-Rater

Communication

Limited-----Comprehensive

Human Resource's Role

Policeman-----Consultant

Ownership

Human Resources-----Line Management

INDIVIDUAL & GROUP VARIABLE PROGRAMS

Individual

Measured Output

Recognition

Commission

Individual Performance

VS.

Predetermined Objectives

Group

Profit-Sharing

Gainsharing

Balanced Scorecard

(behavioral contribution)

“Combination”

(Individual & group)

Recognition

Equity

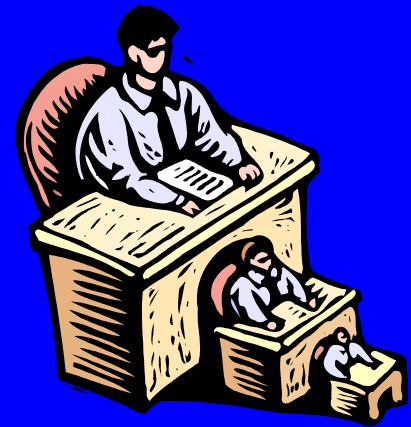
Most appropriate for Organizations at Stage 3 and above

2. A Successful Plan Is Fair to Employees

Must be internally equitable and externally competitive

Performance criteria must be discernible, valid and understandable

Program must deliver what is promised on time and fairly

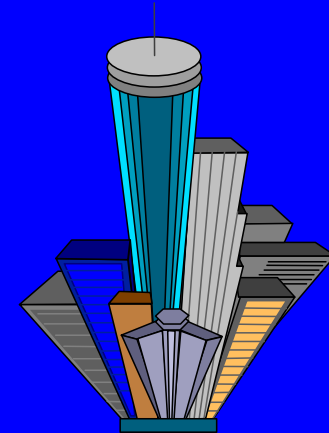


3. A Successful Plan Is Fair to the Organization

Should work towards self-funding

Organization should be relatively profitable when the program is initiated

Plan design should guard against “windfall” payments



4. A Successful Plan Sets Total Compensation (Total Rewards)

Compensation policy must be aligned with **total rewards** and strategic objectives



Variable pay should be *directly* tied to performance criteria achievement: direct line-of-sight

Consider re-defining what is meant by a base salary increase

TOTAL REWARDS PACKAGE (TRP) --- The ‘Holistic’ Approach

Total Rewards Pie



Corporate Values
Personal Values
Intrinsic Motivation
Job Enrichment
Learning and Development
Skill Enhancement
Direct Compensation Programs
(including Shares and Share Options)
Benefit Programs
Perquisites
Work Life/Personal Life

5. A Successful Plan Yields Financial Returns to Employees

Variable opportunities must be perceived as “substantial” enough to motivate performance

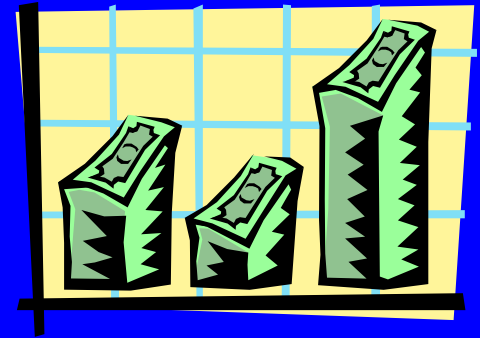


Timing of variable payments should be as close as possible to the qualifying event

If designed properly, payouts to employees will yield “slices from an expanding financial pie”

6. A Successful Plan Yields Financial Returns to the Company

A well-designed and executed variable compensation program can improve the organization's bottom line



Measurable benefits can include improved:

- Morale
- On-time Performance
- Productivity
- Work Methods
- Quality
- Etc., Etc., Etc.
- Customer Service

7. A Successful Plan Involves Employees And Managers

Middle managers will make or break the variable compensation program

Must get buy-in from employees



Should involve employees and managers in the plan design, including identification of performance criteria

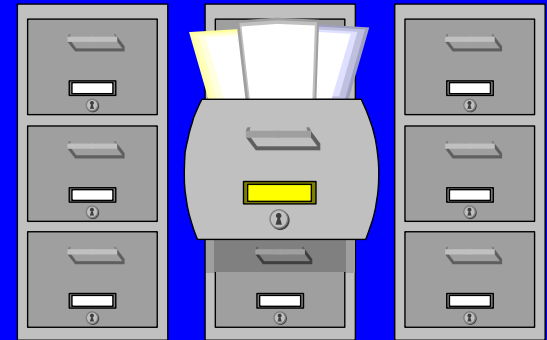
Build trust!

8. A Successful Plan Uses Internal And External Data

Collect and analyze accurate and valid competitive data

Build the variable program from a “rational” base pay foundation

Base salary serves as the *anchor* in total compensation planning



9 (a). A Successful Plan Sets Forth Clear Performance Goals

Performance criteria in successful programs are:

- “cascading”
- a combination of quantitative and qualitative measures
- simple to understand
- supported by valid data
- monitored through strong controls



9 (b). A Successful Plan Sets Forth Clear Performance Goals

Aligning rewards to performance requires the following:

- a clear (and clearly-perceived) relationship between pay and performance
- predictable measures of performance
- visible benefits to the employees and the organization
- regular formal and informal performance feedback



Variable Rewards Program: Performance Management

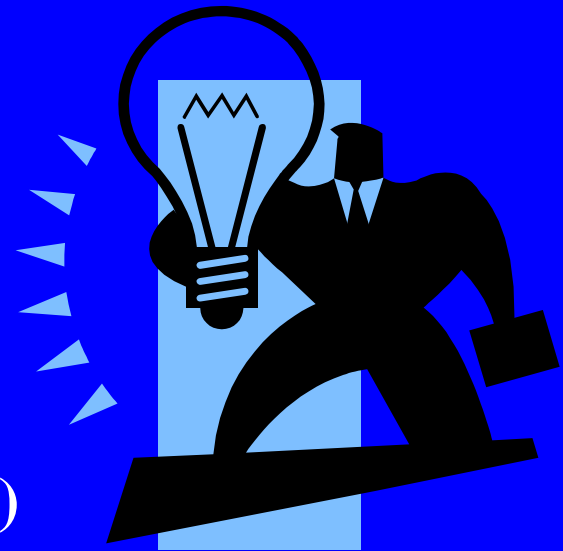
- Corporate criteria are always *quantitative*: measures how the organization defines financial/operational success (2 or 3 criteria).
- Also, develop “**Qualitative**” Corporate Goals (QCG’s): organizational-wide business & operational objectives for the upcoming performance period.
- QCG’s are used to “cascade” Departmental and Individual/Team Goals.

Departmental and Individual/Team Goals should be both *quantitative and qualitative*:

- Criteria must be valid, discernible and measurable and, if applicable, with milestone dates.
- No more than four to six criteria per category.
- Narrative rating scale can be used to assess qualitative criteria.

Why Use Equity To Reward?

- **Align management/employees with shareholders**
- **Build motivation**
- **Conserve resources**
- **Wealth creation**
- **Tax advantages (employer/employee)**
- **Attraction and retention**
- **Capital accumulation**



Equity Programs

Stock Options – the right to buy shares at a set price during a prescribed time period

Stock Awards – stock offered to employees at no cost to them

Two kinds of stock awards:

Performance Shares – opportunity to receive share awards (or cash equivalent) if specified, pre-determined performance goals are met

Restricted Shares – share awards that specify certain conditions be met or shares are forfeited (continued employment, performance objectives)

VARIABLE PROGRAM FRAMEWORK

| TIER | TARGET OPPORT. | RANGE: 0 – 150% OF TARGET | PERFORMANCE WEIGHTINGS | | |
|---------------|-----------------------|--|-------------------------------|--------------|---------------|
| | | | CORP. | DEPT. | INDIV. |
| 1 – Officers | 35.0% | 0 – 52.5% | 70% | 20% | 10% |
| 2 – Directors | 25.0% | 0 – 37.5% | 40% | 50% | 10% |
| 3 – Managers | 15.0% | 0 – 22.5% | 30% | 50% | 20% |
| 4 – Profess. | 10.0% | 0 – 15.0% | 20% | 20% | 60% |
| 5 – Support | 8.0% | 0 – 12.0% | 10% | 20% | 70% |

VARIABLE PROGRAM

Performance Criteria (example)

Corporate criteria (Quantitative):

NET INCOME

(% growth over previous year)

| <u>Criteria</u> | <u>Payout</u> |
|-------------------------------------|---------------|
| MAXIMUM $\geq 17\%$ | 150% |
| TARGET 12% | 100% |
| THRESHOLD 9% | 50% |
| $< 9\%$ | 0 |
| (Interpolate for points in-between) | <hr/> |

Variable Rewards Program Implementation Process: 'Real-Life' Example

- The Company: Business Software Development
(Information Technology)
- 5,000 employees in three countries and five U.S. cities
- Rewards program objectives...
- Specific success criteria...
- Company culture/values assessment...

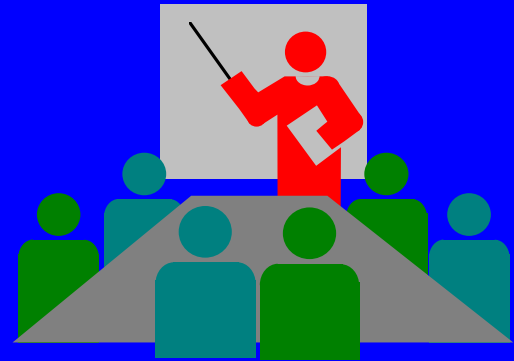
Variable Rewards Program Implementation Process: 'Real-Life' Example

- Rewards program design considerations...
 - Equity
 - Profit Sharing
 - Spot Bonus
 - Recognition
 - Balanced Scorecard (competencies)
 - Direct-Line-of-Sight Framework
- Performance management approach...cascading
- Implementation procedures...
- Management training & employee communication...

10. A Successful Plan Achieves Clarity Through Communication

Communication mega-objectives:

- to ensure understanding
- to change perceptions
(get buy-in)
- to motivate behavior



Even the most elegantly-designed variable program will not achieve the desired results unless employees and managers understand and, ultimately, buy into the program

Top Ten Criteria For Success!

A SUCCESSFUL VARIABLE COMPENSATION PROGRAM...

- *Is Aligned With Organizational Culture/Values*
- *Is Fair To Employees*
- *Is Fair To The Organization*
- *Sets Total Compensation (Total Rewards)*
- *Yields Financial Returns To Employees*
- *Yields Financial Returns To The Company*
- *Involves Employees And Managers*
- *Uses Internal And External Data*
- *Sets Forth Clear Performance Goals*
- *Achieves Clarity Through Communication*

