Developing an Effective Variable Pay Incentive Program

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THE LENZNER SOLUTION

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Effective Variable Pay:

Agenda:

Introduction
  ◦ The Objective of an Effective Compensation Program
  ◦ A Brief Law Summary
  ◦ A Behavioral Theory (Herzberg)

Components of an Effective Compensation Program
  ▶ Internal Equity
  ▶ External Competitiveness
  ▶ Effective Communication
Effective Variable Pay:

**Agenda:**

Components of an Effective Incentive Plan

- The Objective
- The Participants
- The Funding
- The Measurements
- The Targets
- The Administration
- The Communication

Conclusion
Effective Variable Pay:

Business Card Raffle

Two Volunteers: Opportunity to Win!

Earn the MOST True/False Question Points!

Guaranteed Value of at least: $10
Effective Variable Pay:

The Big Picture
Effective Variable Pay:

“Big Picture” Objectives:

**Effective** Human Resources Objective:
To provide advice and counsel in support of an organization’s objectives to attract, retain and motivate a highly skilled workforce focused on achieving short and long term goals through legal, ethical and moral means.
Effective Variable Pay:

The Law:

Need Efficiency!

- Discrimination Law (Title VII, ADEA, ADA, etc...)
  - Disparate Treatment
  - Disparate Impact
- The Equal Pay Act of 1963 (EPA)
- Lilly Ledbetter Fair Pay Act of 2009
  - 180 days from receipt of last paycheck (300 in NY)
Effective Variable Pay:

A Behavioral Theory

Motivator Hygiene Theory

Herzberg

Salary = Brushing Your Teeth

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Effective Variable Pay:

Need Efficiency!

Questions:

1. If you brush your teeth in morning and have fresh breath, how many of you are guaranteed to have “a great day”?

2. If you have a horrible toothache, what are the chances of you thinking about anything else?
Through effective communication it is essential for employees to fully understand how the plan supports business success and that it fairly shares that success.

“Fair, not necessarily happy.”
Effective Variable Pay:

Question 1: \((10\text{ points})\)

A variable pay program will be \textbf{Effective} so long as it is designed \textbf{Efficiently}

\textbf{True or False?}
Effective Variable Pay:

Question 1:

False!

Efficiency: Cutting down a tree with precision

Effectiveness: Cutting down the RIGHT tree
Effective Variable Pay:

Types of Variable Pay
Variable pay is defined as direct compensation that does not become a permanent part of base pay/salary and which may vary in amount from period to period. Where some portion of employee pay is at risk.

Where:
- If individual employees and/or the company meet or exceed their goals, employees earn incentive pay.
- If goals are not met, employees forgo some of the pay they would normally have earned.
Effective Variable Pay:

Types of Variable Pay

- Sales Incentives
- Gain Sharing
- Profit Sharing

- Variable Pay funded by the salary increase budget
The Expected Results:

- Align compensation costs with company’s ability to meet business objectives
- Links employee compensation to individual, team and/or company success
- Focuses and motivates employee activities
- Reduces the perception of entitlement
- Supports an empowering/entrepreneurial environment
- Encourages employee ownership
Effective Variable Pay:

Sales Incentives

- Motivates individuals *(and/or small teams)*
- Rewards for achievement of targets such as revenue, profit, new accounts, etc...
- Employee should be able to *significantly impact* the results
- Payment is “*self funded*” and is based on variables including relationship of base pay to incentive, degree of difficulty, sales cycle, value to organization, etc...
- Payment can be made based on *commission, a bonus* and/or a hybrid of the two
Effective Variable Pay:

Gain Sharing Incentives

- Motivates a major portion of the organization (manufacturing function)
- Rewards for achievement of targets such as productivity, quality, safety, innovation, customer service, etc...
- Employee should be able to influence the results
- Payment is expected to be “self funded” through increased operational efficiencies but:
  - It is possible for an organization to meet its operational goals but not have the required improvement to fund the financial “bottom line”
- Payment needs to include overtime earnings in determining the payout for non-exempt employees
Effective Variable Pay: Profit Sharing Incentives

- Shares success with the entire organization
- Rewards for achievement of profit goals
- Targets are most often linked to achievement of a specific profit level
- Employee has very limited ability to influence the results
- Payment is “self funded” where there is no payment if the profit objective is not met
- Payment does not need to include overtime earnings for payment calculation
Effective Variable Pay:

Variable Pay Incentives

- Shares success with the entire organization (not covered by an alternative plan)
- Rewards for achievement of specified operational and/or financial targets
- Depending on plan design, employees may have a range of opportunity in influencing the results
- Payment is funded through a special budget (often a salary increase budget) where a payment can be made even in times when the business is not profitable
- Payment does need to include overtime earnings for payment calculation
Effective Variable Pay:

Question II: **(10 points)**

Because employees have a greater opportunity to influence their success, Gainsharing is a much better type of plan design than Profit Sharing.

**True or False?**
Effective Variable Pay:

Question II:

False!

While influencing results is ONE important component to plan design there are many others

INCLUDING

Paying out only when the organization can afford to pay out
Effective Variable Pay:

Variable Pay Plan Design:
Effective Variable Pay:

"Key” Design Components:

a. Objective
b. Participants
c. Measurements
d. Targets
e. Funding
f. Communication
g. Administration
Effective Variable Pay:

The Objectives:
Effective Variable Pay:

The Objectives:

- To reward the achievement of goals that are of greatest importance to business success
- To describe required employee behaviors necessary to achieve business success
- To ensure reward is motivational in encouraging and focusing employees
Effective Variable Pay:

The Participants:
Effective Variable Pay:

The Participants:

One Plan for All:
- Simplicity
- All employees focused to same goal

Multiple Plans:
- Better ability to influence measurements
Effective Variable Pay:

The Measurements:
Effective Variable Pay:

The Measurement Keys:

- Linked to business objectives
- Objective
- Trackable
- Understood by employees as “fair”
Effective Variable Pay:

The Measurements:

Operational - Employees able to “directly influence”

- More motivational and easier to communicate for understanding

BUT...

i. Less of a link to business financial success

ii. Difficult for measures to apply across all levels of the organization (production operator, accountant)

iii. To accommodate i and ii, “complexity” would need to be designed into the plan
Effective Variable Pay:

The Measurements:

“Financial Success”

- Guarantees that payouts are only paid out for bottom line success but...
  - i. Employees will struggle to understand how they can influence success (must differentiate from profit sharing)
  - ii. Without understanding, not motivational
  - iii. Confidentiality issues
  - iv. To accommodate i, ii and iii, significant communication efforts must be designed into the plan
Effective Variable Pay:

The Measurements: **Operational**

- **Productivity:**
  - Product/activity per labor hour
  - Reduction in cycle time
  - Meeting deadlines/due dates

- **Quality:**
  - Reduction in scrap, returns, errors – as a percentage activity or sales,
  - Retention/loss of customers due to product performance
Effective Variable Pay:

The Measurements: Operational

- **Safety:**
  - Number of lost time accidents or “medical only” incidents
  - Internal audit results

- **Customer Service:**
  - Customer Surveys
  - Audits of Employee/Customer interaction
  - “Up-sells”
  - Retention/loss of customers due to relationship
Effective Variable Pay:

The Measurements: Financial

- **Profit:**
  - A goal (which could include loss)

- **Return on Assets: net income/total assets**
  - Increased net income for $ value of assets
  - A link to productivity – conversion of investment to profit

- **Cash:** Assets able to be converted to currency
  - Linked to liquidity – paying debts, reduced borrowing
Effective Variable Pay:

The Measurements: Financial

- **Revenue:**
  - Where revenue is a good predictor of profit

- **Expense Reduction**
  - Linked to return on assets and Cash
Effective Variable Pay:

The Targets:
Effective Variable Pay:

The Targets:

- A “Stretch but achievable”
  - Value to the Organization
  - Motivation
  - Risk vs. Reward

- Goal Setting
  - Past Performance
  - Future Requirements for success

- Business Cycle
  - Start Up
  - Growth
  - Mature
Effective Variable Pay:

The Targets:

- Risk Consideration

- Elements
  - Threshold
  - Goal (100%)
  - Cap?
Effective Variable Pay:

The Risk:

- High Risk
- Moderate
- Low Risk
Effective Variable Pay:

The Targets:

The “Slope”

- **Regressive**
  - Additional success pays out less as success grows
- **Flat**
  - Additional success is paid out equally as it grows
- **Progressive**
  - As success grows, so does payout amount
Effective Variable Pay:
The Slope:

- Regressive
- Flat
- Progressive

Threshold 100% Cap
Effective Variable Pay:

Linking Multiple Targets:

- **“Independent” Measures**
  - Each measure paid out regardless of performance of other measures

- **Matrix**
  - The better the mix of measure success, the better the payout

- **Gates**
  - If one or more goals not met, no payout regardless of other goal performance
Effective Variable Pay:

Independent Measures:

- Productivity: 40%
- Quality: 30%
- Safety: 30%
## Effective Variable Pay:

### Matrix: Productivity and Quality

<table>
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<th>80%</th>
<th>90%</th>
<th>100%</th>
<th>110%</th>
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<tr>
<td>80%</td>
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<td>2.5%</td>
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</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Quality</th>
</tr>
</thead>
</table>
Effective Variable Pay:

Gates:

Measures:
1. Profit (50%)
2. Cash (25%)
3. Return on Assets (25%)

NO payout unless Profit = 70% of Objective
Effective Variable Pay:

Funding:
Effective Variable Pay:

Funding:

- Affordable
- Motivational
- Controlled
Effective Variable Pay:

Funding:

Self Funding:
• Pay out when additional earnings are achieved
  • bad year retention

Funding from General Budget:
• Pay out regardless of financial business success
  • bad year affordability

Salary Increase Budget
Effective Variable Pay:

Funding:

Salary Increase Budget

- Initial Funding: At least 2% \((\text{motivational} = $40,000 = $800)\)
- From Salary Increase Budget
  - If budget = 3%
    - 1.5% goes into base pay
    - 1.5% goes into variable pay
Effective Variable Pay:

Funding:

Salary Increase Budget

- Funding goes on **in perpetuity**
  - If in base salary, would be fixed cost going forward
  - In variable pay, it would be same fixed cost* but would be pay at risk
## Effective Variable Pay:

### Funding:

<table>
<thead>
<tr>
<th>Year</th>
<th>Salary Increase Budget</th>
<th>Salary Increase Component</th>
<th>Variable Pay Component</th>
<th>Variable Pay Opportunity</th>
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<td>3%</td>
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<td>6%</td>
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</table>
Effective Variable Pay:

Question III: *(10 points)*

Funding Variable Pay through a Salary Increase Budget is definitely the best way to go!

*True or False*
Effective Variable Pay:

Question III:

**False!**

Every plan needs to be considered based on its own individual circumstances.
Effective Variable Pay:

Question III: False!

Individual circumstances

- Start Up and Growth Phases
- Unhooking due to business change
- Retention issues due to pay (base pay perceived as too low, variable pay does not pay out regularly)
Effective Variable Pay:

Administration:
Effective Variable Pay:

Administration:

- “Things Change”
- System Requirements
- Frequency of Payment
- Same/Different Payouts based on Position
- Hire/Transfer/Separation of Employees
Effective Variable Pay:

“Things Change”

- “The company reserves the right to modify or terminate the plan at any time for any reason”

- Communication as to when measurements and/or targets may be modified

System Requirements

- Simplicity vs. Complexity
  - Frequency of payments
  - Transfers
Effective Variable Pay:

Frequency of Payment

(typically between quarterly and annually)

- “Success” Cycle (volatility during year)
- Motivation expectation of workforce
- Complexity to pay out
Effective Variable Pay:

Different Pay for Different Positions
(typically a % of pay)

- External Competitiveness
- Complexity of communication
Effective Variable Pay:

Hire/Transfer/ Separation of Employees

- Multiple plans more complex
  - Transfer between divisions/functions
  - Change in positions

- Prorate: Number of Full Months in Company, new function, division, position

- Employed on date payment is distributed
Effective Variable Pay:

Communication:
Effective Variable Pay:

Communication:

All Employee Meeting at start of year

- Company/Plan Objectives
- What it means to employees
- Administration Rules
- How employees can influence
- Allow two way communication
Effective Variable Pay:

Communication:

Monthly/Quarterly Meetings

- How Company did
  - For confidential financial measures – achievement vs. 100%
- Payout (if any)
- Plans to improve for next month/quarter
- Allow two way communication
Effective Variable Pay:

Communication:

Annual Meeting *(for annual plan)*
- How Company did
- Payout (if any)
- Objectives /Payout opportunity for next year
- Any change in measurements/targets
Effective Variable Pay:

Question IV: (10 points)

Regular communication is the most important component of gaining employee buy-in and motivation to a variable pay plan

True or False?
Question IV: False!

The target is even more important!

- How motivated would a Human Resources Manager be if she met daily with the CEO and was told:
  - “You will earn a $1 million bonus if you can help us grow our market share from 5% to 95% by the end of the year”

“A stretch but achievable”
Plan Design Example:

- **Plan Objective:** To align all employees towards the achievement of company profit objectives through increased productivity, quality, safety and revenue.

- **Participants:** All with aligned, but different, goals *(manufacturing, sales, company)*

- **Funding:** 2.5% from salary increase budget
Effective Variable Pay:

Plan Design Example:

Measurements:

**Operational (factory)**
- Productivity measure per labor hour
- Returned good $ as a percentage of sales
- Number of lost time/medical only accidents

**Sales (Sales – modified for Customer Service)**
- Revenue
- Gross Profit
- New Accounts

**Financial (Office, Executives)**
- Gross Profit
Effective Variable Pay:

Plan Design Example:

Measurements:

Targets:

- Achievable improvement from last year’s performance

Payout:

- Threshold of 60% for Factory, 80% for Sales/Office
- Payout opportunity for Office 2S that of Factory
- Cap of 130% (except for Sales)
Effective Variable Pay:

Plan Design Example:

Administration:

- Plan document presented with “necessary legalese”
- Prorated payment for new hires
- No payment unless employed on date of payout
- Quarterly payouts for operational success
- Annual for financial (overachievement)
Effective Variable Pay:

Plan Design Example:

Communication:

• Introductory meeting announcing plan

• Quarterly meetings:
  • Operational payout earned
  • What was accomplished in previous quarter
  • What are goals are for next quarter
  • What is needed to do to accomplish

• End of year meeting to also communicate:
  • Financial results
  • Set new measurements/targets for next year
Effective Variable Pay:

Final Considerations

- Constantly review:
  - Measures/communication to ensure they are aligned with business objectives
  - Payout amount to ensure it is both affordable and motivational to employees
  - Targets so that they are perceived as a stretch but achievable

- Do not communicate plan as variable pay or gainsharing if it is profit sharing
Effective Variable Pay:

Final Considerations

- Set threshold low enough to permit payout in first year
- Set cap to limit opportunity for unearned “windfalls"
- Do not let program degenerate into an entitlement
- Be prepared for extensive communication program if after you cancel the program after growing Variable Pay Fund from salary increase budget
Effective Variable Pay:

Conclusion:
Effective Variable Pay:

Conclusion

- Incentives can be a very effective tool in aligning and motivating employees
- They should not be considered a replacement for base salary or benefits (*limited impact towards attraction/retention*)
- Targets must be a stretch and achievable
- **Effective Communication** leads to more Understanding
- An **Effective Program** is worth the effort but if you don’t think your organization can be effective – *don’t try*
Conclusion

Effective Variable Pay:

The overall goal is to win!
Effective Compensation Program: Fact or Fiction

Question V:

This is the BEST Compensation Presentation you have ever seen!

True or False?
Effective Compensation Program: Fact or Fiction

Question V:

True!
For reasons unnecessary to expound upon

50 points!
The End
Effective Variable Pay:

The Measurements: Financial

Note: Confidentiality

- Would communication of actual financial results impact competitive position?
  - Customers looking to reduce price
  - Assisting competitors in setting objectives