

# Bullet-Proof Your Compensation Program

By Aria Glasgow, Pearl Meyer & Partners

The talk at the water cooler lately has been decidedly less upbeat. Instead of home renovation projects, new cars and big raises, much of the conversation is focused on falling home values, soaring gas prices and worried speculation of where the economy is headed. Memories of the collapse of the dot-com bubble are all too fresh in people's minds and the current economic picture seems worrisomely similar. The current downturn is hitting people's wallets even more directly, in the form of rapidly rising prices for milk, bread and gasoline.

However, the compensation environment has changed from seven years ago. The cheap compensation currency of the technology boom throughout the company ranks was stock options, which at that time incurred no charge to the bottom line. The subsequent market collapse taught employees the other meaning of "underwater," while corporate scandals sparked a host of changes in the treatment of compensation, from the heightened oversight of Sarbanes-Oxley to mandatory option expensing to expanded proxy disclosure. A continuing decline in option use for

## QUICK LOOK

- ➔ Invest in programs to retain critical employees, in order to avoid having to spend money later on to hire replacements.
- ➔ Determine the functional areas that are most critical to your company's success and target those employees at a higher market position.
- ➔ Make sure management understands the plan modeling of best- and worst-case scenarios.



# *It's not enough to know*

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non-executive employees over the last few years requires that companies now primarily focus on base pay and bonus programs to help attract, retain and motivate existing and prospective employees.

A downward economy has a direct impact on compensation program design and budget planning, forcing HR departments to compete for more scarce resources. However, compensation experts who generally thrive on data and advance planning tend to be less comfortable with financial uncertainty. This article suggests six steps to help compensation professionals start preparing their organizations for what's ahead, and helping you ensure that your company's board continues to support your total compensation strategy. (See Figure 1.)

## 1. Consider Future Workforce Changes

### Clarity on Strategic Approach to Workforce

In times like these it is all too easy to sacrifice the long-term in order to avoid short-term budgetary short-falls. Compensation professionals should be thinking now about their long-term workforce needs. While the HR function may not make the final decisions, its staff should be providing critical analysis and recommendations to leadership regarding the impact on compensation programs.

Obviously, staff changes will be based on the company's financial condition and general corporate culture. But organizations also should prepare for a worst case scenario — from cutting merit spending to reducing head count. If there is a process in place to easily identify "poor performers," costs can be reduced by targeting this group. Another alternative is to invest in programs to retain critical employees, in order to avoid having to spend money later on to hire replacements. Some companies may prefer to take a broad-brush approach to cutting back, such as freezing merit budgets or eliminating bonuses, so that everyone feels a little pain.

### What Worked Before?

Consider how well the company handled the last downturn and what lessons were learned. Were jobs or expenses cut too quickly, or too late? One company took a two-pronged approach when costs needed to be cut in 2002 by terminating employees previously identified as poor performers and imposing a nearly two-year-long merit and bonus freeze. No one was happy about missing out on either a raise or bonus, but in the end the company avoided large-scale layoffs and remained profitable.

## 2. Understand Your Competitive Position

### What Is Your Current Market Position?

It's not enough to know an organization's base salary is 2 percent above market; there should be an in-depth understanding of the organizations' competitive position, both by reward element and by functional area. What is your company's position on target and actual total cash and total direct compensation? In weak economies, actual compensation becomes more relevant than target levels. What does the organization offer employees besides compensation? Base salary might be below the 50th percentile, but a robust benefits program with low health-care premiums and generous vacation schedules can help compensate. One company is launching an internal campaign around the company's non-cash rewards that will help it remain an employer of choice, even though compensation is not above-market. Whether the carrot is tuition reimbursement, an emphasis on work-life balance or another program designed to enhance the work experience, such rewards can boost an organization's overall competitive position.

### What Is Your Desired Market Position?

The next step is determining where the organization wants to be competitively. Targeting all functional areas at the same exact market position, whether the 50th, 60th or 75th

percentile, is the approach most companies take. But it may cost more in the long run if some positions are overpaid and others come up short, risking the loss of desired employees and turning off potential hires. Determine the functional areas that are most critical to your company's success and target those employees at a higher market position. In areas with a wider pool of talent, or functions that aren't as critical to your organization, pay levels can be targeted at a lower competitive position.

### What Are Your Competitors Doing?

If another company in the industry or one located down the street boosts pay for positions your company needs, you may have to follow suit. As discussed earlier, if a salary can't be matched, market where your company shines, whether it's an innovative sabbatical program, a more entrepreneurial culture, or other unique programs.

One of the best sources for information about the competition is from your recruiters. They will often have the most up-to-date information about which companies are offering higher starting salaries or implementing flexible work schedules, although their data may be biased toward the high side. They will also be the ones who quickly learn where there may be opportunities to hire additional talent if the competitor's employees are starting to leave an organization.

### 3. Bullet-Proof Your Plan Design

#### Model All Variable Pay Plans for Best- and Worst-Case Scenarios

The next step is to model best- and worst-case competitive scenarios for total cash and total direct compensation. It is important to include "target" and "actual" scenarios, as any differences could dramatically impact the amount your company spends on incentive plans.

#### Review Plan Measurements and Instrument Alternatives

Performance measures should be appropriate, with the right balance between company, business unit and individual performance. Other issues to evaluate: Is the performance period long enough to be meaningful? Do the bonus-plan metrics support business strategy? For example, if your

FIGURE 1: COMPENSATION PLANNING IN AN UNCERTAIN MARKET



company is coming off an aggressive growth period, performance metrics may need to be updated. Bonus plans with metrics tied to incremental growth from the prior year may be difficult to achieve in a weak economy. Also, if the accounting cost of using stock options is too high and/or grants seem more likely to end up under water, consider other long-term incentive alternatives.

Take a look at your sales plan. Finding and competing for revenue is even more important in a downturn and compensation expenses should be allocated appropriately. Is your company getting the biggest bang for its buck? To what extent does the plan benefit your company and how much should profits be shared? Is your compensation plan simple enough to be truly motivational? If the sales staff does not really understand just how they are paid, the program needs to be tweaked or, at the least, more clearly communicated.

#### Assess All Compensation Programs

Review all of the compensation programs you have in place in terms of how they work and the likely impact of a downturn. For example, how are merit budgets determined from year to year? Is there a forced ranking system, or will a reduced merit budget lead to rating inflation? Smaller reward programs should be evaluated to determine which programs should be cut first if needed.

# Be prepared to deliver

what might seem like a mixed message, especially early on.

## 4. Integrate Compensation and Communication Strategies

Every tough decision calls for a specific communication strategy, even if the best strategy is to say nothing at all. Ask some key questions:

- How much information should or must be disclosed?
- When should it be communicated?
- Who should make the announcement? (CEO/human resources/compensation)
- What is the best way to get the news out? (e.g., e-mail, memo, Q&A, employee sessions)

Be prepared to deliver what might seem like a mixed message, especially early on. One employer is still experiencing a dot.com hangover, characterized by above-average bonus targets that are unrealistically high. The company is performing reasonably well, but its incentive program is due for a significant overhaul that may result in reduced targets for some employees.

Be prepared to repeat, multiple times and in multiple formats, how and why a program is being changed.

## 5. Ensure Line-of-Sight

### Communicate with the Executive Team

One of the worst-case scenarios for compensation professionals is having the CFO dictate which compensation programs must be cut. Make a point of having at least one member of the HR or compensation staff establish a relationship with a member of corporate leadership who understands the company's compensation programs. It may not avoid cuts entirely, but when a compensation department is at least asked for cost-cutting ideas, high-level decisions are likely to be more thoughtful and more supportive of the organization's total compensation strategy.


### Be Proactive with Analysis and Recommendations

Make sure management understands the plan modeling of best- and worst-case scenarios and the impact on the organization's competitive position. Ensure that any cuts or

other changes are communicated to employees as company decisions, and not that programs are being changed by the compensation department.

## 6. Business as Usual

Finally, organizations should take special care to remain focused on the elements of their total rewards program that are continuing to work well. Even if a merit freeze is necessary, employee performance reviews should not be neglected. Make an effort to preserve relatively small extras like spot bonuses and consider offering new, relatively lower-cost benefits such as additional vacation days or telecommuting arrangements.

There is only so much a company can do to try to predict where the economy is headed. Ultimately, the real key to successfully handling uncertainty is simple: Don't panic, just be prepared. 

### ABOUT THE AUTHOR

**Aria Glasgow is a vice president with Pearl Meyer & Partners and is based in Boston. She can be reached at [aria.glasgow@pearlmeier.com](mailto:aria.glasgow@pearlmeier.com) or 508-630-1516.**

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