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How to Build a Compensation Program Based on Business Strategy

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The best way to ensure that your compensation strategy is "right on the money" is to make it a direct extension of your business strategy, stresses **Jim Hudner**, **Managing Director** at compensation consultancy Pearl Meyer & Partners (www.pearlmeyer.com). "Compensation is a powerful way to communicate messages to employees about how they should conduct themselves on the job. Their actions and behavior are what drive business results," he notes. The way you pay them—and the things you pay them for—tells them precisely what behavior you want to see.

"If compensation programs are not linked with business strategies, you may discourage the right behavior—or even encourage the wrong behavior," Hudner warns.

Hudner acknowledges that all organizations struggle to make the all-important link between business strategy and comp strategy, especially at the non-executive level. "It is much easier to make a direct connection at the executive level, since senior leaders have the ability to make changes that directly impact the business and the clearest line of sight," he explains. "At many companies, however, that impact diminishes as you move down in the organization."

Here are Hudner's recommendations for building a compensation strategy that is effectively linked to your business strategy throughout the organization:

Clearly determine your business's competitive focus. "This starts with the HR/compensation director sitting down with senior leadership to pinpoint the basis on which your company is competing in the marketplace. 'What is our organization's competitive advantage? Why will customers use our goods and services?'" Hudner says.

For example, you may compete primarily on cost, differentiation in the market (to appeal to mass consumers), customer focus (the best service in the business), or reputation within a specific niche market.

"Your compensation plan needs to take those competitive factors into account first," Hudner advises. "For example, if you're competing on cost, using a 75th percentile pay positioning for most of your population would conflict with your business strategy."

Tip for success: "Define those areas/disciplines in which your organization absolutely must excel in order to execute your business strategy, whether it is marketing, sales, research, innovation, etc. These are the priority behaviors you need to reward," Hudner says.

Define your competitive position vis-à-vis compensation. "Define the competitive posture at which your organization needs to compete for different segments of the employee population," Hudner says. "For example, do you need to be at, below, or above market?

"Also, identify with whom your organization competes for personnel. The talent pool is not homogeneous for most organizations: for example, large, complex health-care organizations compete in a specialized market for nurses and medical technicians, but must vie with general industry for finance and HR talent.

"You then need to determine how to most effectively allocate your compensation dollars among base salary, short-term and long-term incentives. For example, asset-management firms tend to provide relatively little compensation in the form of base salary as compared with incentives, while at most nonprofit organizations, pay is primarily delivered in base salary," Hudner points out.

Get a good grasp of your corporate culture. "Have a clear understanding of whether you want to build on your current organization's current culture, or use compensation as an agent of change," Hudner notes. Compensation should always support your organization's desired culture.

Establish which behaviors you want to reinforce. For example, if your priority is to encourage more teamwork, then your compensation strategy should be focused on rewards for collaboration and team results, more than individual performance.

Decide how to best segment employees. "The most strategic compensation strategies are not 'one-size-fits-all,'" Hudner says. "Different functions have different demands in the marketplace and should be compensated accordingly—and even within a given function, different roles may be more critical to the business than others."

Model cost impacts. "Have a clear understanding of the potential cost of each compensation strategy you are considering and its likely impact on employee relations," Hudner says.

Link your comp strategy to other HR programs. "Never overestimate the power of pay alone to keep employees motivated and engaged. While pay is generally a consideration in decisions about whether to join or stay with a particular organization, other factors—such as benefits, work environment, company reputation, and working conditions—can play an even bigger role. Consider how your compensation strategy will affect other financial benefits such as medical, paid time off and retirement, as well as non-financial benefits such as work schedules, telecommuting and programs to improve work/life balance," Hudner continues. "In some cases, pay just needs to be a 'neutral' factor in employment decisions and not a de-motivator."

Keep your pay strategy flexible. "Rapid technological change and globalization call for a shorter planning cycle than in the past, requiring a compensation strategy that is nimble enough to be tweaked or overhauled quickly to support changes in your business strategy," Hudner says.

"For example, a young organization focused on building market share needs a pay program that supports that goal. When it advances to the point of looking for profitable growth, the organization's pay program should be redesigned to reflect those new goals."

Integrate a clear communication plan into your comp strategy. "Organizations need a well-thought-out plan for communicating programs to employees that fits the organization's culture," Hudner says. "Too often, there is a lot of fanfare when a new pay program is introduced, but the communication ends there. Deliver a clear and consistent message to employees about why and how they are being paid."

Avoid common pitfalls. Compensation strategies often fail for one or more of the following reasons, Hudner cautions:

Poor understanding of business strategy. "Particularly in small and/or new companies, business strategies and plans may be understood and communicated only at higher levels of the organization," Hudner says.

Weak collaboration between senior leadership and the HR/comp function. If senior leadership views compensation as a financial expense and administrative issue, rather than as a key strategic investment, HR is likely to lack the top-down commitment needed to make its pay strategy work.

The "It worked at my last company" syndrome. HR/compensation professionals may be tempted to roll out a compensation approach that worked at a previous employer, without considering the unique aspects of the new company's business. "All organizations are unique. What worked at one company may be disastrous for another," Hudner warns.

Lack of infrastructure. "Compensation strategy falls apart without a strong support system that incorporates performance metrics, a performance-management process, and training for line managers in communicating programs to employees," Hudner says. "A program that is effective in theory can die on the vine without an adequate timeframe and sufficient resources to implement and administer."

Know the warning signs that you need to fix your pay strategy. There are three key warning signs that your compensation strategy is failing, Hudner says:

Employee behavior isn't where you want it. "It usually takes between 18 and 36 months once a new pay strategy is put in place to see some divi-

dends," Hudner observes. "If after some period of time the compensation strategy is not driving or supporting changes in behavior that lead to business results, it needs to be reevaluated."

You're not attracting and keeping the right talent. If it's getting more difficult to recruit top talent or you're losing good new hires, the culprit may be a poorly designed, badly executed or outdated compensation strategy.

Your business strategy has shifted, but not your pay strategy. "Any change in your business strategy needs to be accompanied by the question, 'What do we need to change in how we pay our people?'" Hudner advises.

Assess the measures of success. Look at the aggregate effect of the following measures of success:

Turnover is at the desired levels. "You are not only keeping the people you want to retain, but also losing the ones you don't want to keep," Hudner points out.

There is a measurable return on investment. "Look at your total compensation expense (salary plus bonus plus long-term incentives), taken as a percentage of net income or revenue. If that ratio is flat or decreases over time, it indicates that you are achieving good results," Hudner notes. "Your goal is to generate business results while stabilizing or reducing compensation costs."

Achievement of business results. If within 18 to 36 months of implementing your compensation strategy you see improvement in key business indicators such as revenue growth and market share, it is a safe bet that your compensation strategy is having a positive impact—"particularly on those employees who really drive results," Hudner concludes. ❑

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