Principles of Compensation

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The following principles of compensation are timeless...

They should not be abandoned during different labor market cycles and different economic cycles

Principle # 1

> Compensation is a management tool. There is no simple school solution. The best compensation solutions come from understanding the current underlying business problem.

> Compensation comes in two sequences:

-One is the pay strategy developed for organizations and jobs

- The other is the actual pay received by employees and the reasons for that pay (We often blend these two concepts and lose our way)

Principle # 2

> Most organizations operate under a "BASIC CONTRADICTION" when designing their compensation programs.

- They claim to be different from anyone else, But

- They want market place confirmation that what they are doing is right.

>Market place confirmation is tricky- I can show you a piece of data to prove any point you are trying to make, on any subject, at any time.

>Data is not an answer...data requires interpretation and judgment

Principle # 3

> Even if companies are in similar businesses they differ by:

• Culture

• Management Style

.• Internal Economics

.• Level of Maturity

• Ownership

Each has an implication for compensation program design.

Principle # 4

> There are "Determinants of Compensation"

1. Job Content, Job Expectation and the importance of the job to the Company

2. Labor market supply and demand factors

3. Internal company economics

4. External market factors, including geography

5. Special Industry Practices

6. Company economics and strategy***

Principle # 5***

>The sequence for determining pay strategy:

1. Business examination of:
   - internal economics
   - external market pressures
   - philosophy of compensation in relation to business issues

2. Examination of different "lines of business" within the company:
   - may require different pay strategies, styles or levels

3. Understanding key expectations of jobs within the organization

4. We should not consider how we pay people in their jobs until we have set the appropriate strategy for pay

" How do we want to run our business, what do we value, what are we willing to pay for?"

Principle # 6

> There are Four Key Questions in Compensation:

1. How much? (What target level of compensation?)

2. Of what? (salary, incentives, executive benefits, gainsharing?)

3. To whom? (Which participants in which plans?)

4. For What? (What level of desired job performance triggers the target Payouts of various programs?)

Principle # 7

> Know the Business Life Cycle of the Company, the Industry and the Business Unit.

1. Start up

2. Growth

3. Mature

4. Stable or Harvesting

>Each stage requires a different approach to pay programs and cash flow

Principle # 8

>Market Stage Influence on Compensation Strategy

Compensation Elements	>------------Emphasis by Market Stage----------< Start up	Growth	Mature	Harvesting
Base Salary	Low	Moderate	High	High
Short Term Incentives	Low	Moderate	High	Moderate
Long Term Incentives	High	High	Moderate	Low
Retirement Benefits	Low	Moderate	High	High
Health and Welfare Benefits	Moderate	Moderate	High	High
Perquisites	None	Low	Moderate	High

> A company must consider its internal economics when designing programs
> The dot.com era completely missed this point

Principle # 9

> It is critical to understand the business issues which underlie the compensation questions presented!!!

> Most managers cannot be convinced to implement a new or revised compensation program if they are not convinced of the underlying business implications

Principle # 10

> It is desirable (if not outright required) to pay for "<u>realized gains</u>" as opposed to calculated projections or as yet "<u>unrealized gains</u>" gains. (another Dot.com error)

> Increased value of compensation payouts should reflect increased gains to the organization.

Principle # 11

> "Don't take another patients medicine"

> It is unlikely that you have the same problem

Principle #12

> Because of limited economic resources there is a tendency to minimize or forgive the importance of performance management

> Performance Management is a way of operating a successful company and should be instilled as a way of life in a company...in order to have a performance driven company which values growth and productivity. This is a "how do I want to run my business" issue.

Principle # 13

>There is a trend to use equity (stock, options, performance shares) in many Public, Private, For-profit and even Not-for-profit organizations.

- the advantage: it focuses behavior on total company issues

- the disadvantage: it does not focus on business unit or job performance

>Recommended Principle:

* Pay your employees to drive focus on all aspects of their jobs, Including Organization, Business Unit and Individual Measures

Principle # 14

> There are <u>seven</u> core components of compensation:

1. Base salary programs, including salaries and salary increases

2. Short Term Incentives, including annual, gainsharing and spot awards

3. Long Term Incentives, including actual stock or simulated equity

4. Health and Welfare Benefits, including health, life and disability plans

5. Retirement and Capital Accumulation Benefits, including defined benefit and defined contribution plans and supplemental plans

6. Perquisites, including financial planning and security measures

7. Alternative*** non-monetary reward systems such as telecommuting

Principle # 15***

> Consider every aspect of compensation as an <u>alternative</u> for your company

> Base this consideration on what your business needs in order to succeed to <u>attract</u> and <u>retain</u> qualified key employees and, leaders and achieve successful <u>performance</u>

Principle # 16

The philosophy of "Entitlement Programs" is dead!

They are replaced by performance requirements, success sharing and risk sharing!

Principle # 17

> When developing a market comparison strategy companies often confuse the market place for people with the marketplace for business competition. (Where do you get your people and where do they go when they leave)?

> The competitive marketplace in compensation planning is the marketplace for people!

The Role of the Economy and the Role of 9/11

Regarding 9/11:

There is tendency to blame company performance on what the events of 9/11 did to the company.

Look at the company as of 9/08 to determine what issues you were facing at that time.

Regarding the economy:

Examine company strategies and how they vary at different need points:

Issues Jan 1998
Issues Jan 2000
Issues March 2002 Do you respond to different economies at different times?

Finally:

> Communicate with employees…as often as possible

> Educate Top Management about the issues (sometimes 110% of the problem)

A Brief History of Compensation Milestones

1. Prior to 1970, there was little in the way of "Executive Compensation". Most employees and executives received base salaries, some bonus, and benefits.

2. In the early 70's when Business Week published its annual list of top paid, no executive received more than $1MM, and it appeared that no one wanted to be the first to be paid $1MM

3. When the million dollar mark was broken, it was like a flood gate had broken.

4. In 1978, the biggest milestone in our era, the capital gains tax was differentiated from the ordinary income tax, giving great value to receiving stock options

- this opened the door to the greatest competitive posturing in the financial services industry which spilled over everywhere

- the venture capital industry as we know it was born because venture capitalists received their gains in stock, taxed at a much lower rate.

- bank employees formed venture capital units (the most famous was Henry Kravis) and to compete offered their captive venture units stock as if they were free standing companies

- the spill over to other aspects of financial jobs and ultimately to the executive jobs in every aspect of the economy was enormous. Everyone wanted stock as part of their compensation package for tax purposes.

5. The excesses of the 80's led to a disastrous market crash in 1987. Stock lost its glimmer, and executives wanted big salaries again.

6. Armed with new salaries, the recovery was quicker than most predicted and the perception of stock value was back.

7. The dramatic revolution in technology and the Dot.com phenomena in the mid 90's forced companies to pay with money they did not have…valuable stock…the pot at the end of the rainbow.

8. When the bubble burst, stock again became less useful. At the same time salaries were outrageous, for companies that had no cash to spend, and at the same time companies ignored business models which had been successful for so many years.

9. The latest circumstances (there are three) all effect compensation planning:

a) the economy since 1998
b) September 11
c) Enron/Arthur Anderson

10. It is my opinion that the biggest impact will come from the Enron/ Arthur Anderson fallout because more constituencies than ever before are watching to see just how employees and executives are actually paid.

11.We too often have left business fundamentals to give in to the market pressures, and each time we have “lost our way”