Variable Pay Plans

The last two articles in this series discussed how to develop a compensation philosophy as well as the elements of a base pay plan. In this article we will discuss variable pay plans.

First, what is a variable pay plan? It really is, as the name suggests, a pay plan in which the level of the award varies with some metric. This metric is normally tied to company or unit performance. It also may have an individual performance metric as well.

There are typically two main categories of variable pay plans. One is a bonus plan, the other is an incentive plan. A bonus plan is one where the bonus is awarded after the fact and typically has very little or no incentive value. The employees typically come to see it as an entitlement.

An incentive plan is a variable pay plan that is tied to some level of performance. The employee is rewarded with a payment that is predefined and non discretionary. The reward is paid when actual performance meets or exceeds predefined goals.

While many companies include long term incentive plans for executives, we typically see incentive plans that are short term in nature covering the majority of employees. By short term we mean no more than one year in duration. Another type of incentive plan is the sales incentive or sales commission plan. We will only address the short-term incentive plan in this article.

Philosophy

A typical philosophy statement might go something like the following:

> A substantial portion of the annual compensation of each executive and some portion of all employees' compensation will relate to and be contingent upon the performance of the Company. This is intended to align the interest of employees with those of shareholders, customers, and the Company.
>
> The short-term incentive payments when combined with base salary should raise the total cash compensation of most employees to a level above the market average. These two pieces of compensation make up the majority of the employee's total cash compensation.

According to the Corporate Leadership Council, performance measures serving as basis for performance pay should vary according to 'line of sight', i.e. the relationship between the measurement and employee's direct influence/control over them. Absolute financial measures such as return on average assets or net operating income typically are appropriate for senior executives.

The line of sight principle helps to formulate the following criteria for effective performance pay measures.

- Relate to significant contribution to the business
- Be subject to employee's influence/impact
- Be clearly understood
- Be easily measured

In addition if a performance culture is desired, following is a list of items that are critical to the success of that culture:

- Develop appropriate measures and clear goals
- Improve linkage/line-of-sight
- Effective communications
- Top management support
- Accountability for performance

Before a company sets out to develop an incentive plan, a set of goals for the plan should be developed.

The purpose of the incentive plan is to:

- Drive individual accountability for accomplishment of those objectives most important to Company success with a focus on reaching strategic and operational goals;
- Maintain and reinforce the importance of annual objectives that support long-term bottom line results;
- Encourage achievement of stretch objectives related to profitability and growth, and provide compensation opportunities as the reward for their attainment;
- Encourage alignment as a means of achieving ongoing success; and
- Provide for additional compensation opportunity based on organizational, unit and individual results.

The connection between performance and rewards is often called **line of sight or line of influence.** It refers to the fact that in order to be motivated in an organizational setting, people must see how their behavior influences a performance measure that, in turn, drives the allocation of a reward. If incentive plans are designed and administered well and they fit the situation in which they are used, there is clear evidence that they can affect performance positively.

There are a number of factors that should be considered when developing a variable pay plan. They include:

Who is going to participate: Incentive plans should be designed with the purpose in mind. Will it be a plan that covers the individual employee, such as a sales incentive plan, or will it cover all employees or somewhere in between. Most companies will have more than one incentive plan. For example, if the following four areas are included then there needs to be four different incentive plans:

- Outside Sales representatives
- Inside Sales Representatives
- Top Management
- Production workers

Each of these requires a different set of metrics if the plan is to really drive the desired behavior. Each of these groups of employees has a different line of influence and therefore, should be paid on a different set of metrics.

This brings us to the next factor – that of the criteria for judging performance. Chapter Ten of the recently published book titled **Executive Compensation, The Professional's Guide to Current Issues and Practices,** is an excellent set of directions for developing metrics for executive incentive plans.[1]

Those metrics outlined in that Chapter will vary from the metrics that fit a production worker. The metric that fits the executive incentive plan will deal with corporate performance and corporate strategy while the production worker will deal with cycle time, quality, safety, through put, etc.

The next factor deals with the length of the performance period. For the executive it is typically one year for the short term incentive plan, for the sales representative it the sale, although it might not be paid until the end of the month or quarter. The production worker may be the same, monthly or quarterly. The key here is how long does it take to see the end result of the performance that is being measured.

If a Company is developing an incentive plan for the first time, another factor to consider is where is the money coming from? Will it come from part of the current base pay, will it come from the plan year's merit budget, or will it be a budgeted item, realizing that the payment, if any, will increase labor cost the first year. The answer to these questions depends upon the company's compensation philosophy and how well the current pay practice is in tune with market pay.

Intertwined with the above factor is how much is paid at goal performance? Should it be the same dollars for everyone, or should it be the same percentage of pay for everyone or should the payment vary by position level? The "normal" practice is to put more of the total cash compensation at risk for those positions at the top of the organization versus those positions at the bottom of the organization.

We typically see the short term variable pay for the CEO to be between 75% and 100% of base salary for target performance, while at the lower levels the percentage at risk might be between four and eight percent. It really depends upon the compensation philosophy for the company and how much the company wants to drive performance of the individual.

---

[1] Ferracone, Robin A., Selecting Performance Measures and Setting Goals, in Executive Compensation the Professional's Guide to Current Issues & Practices, Editors, Davis, Michael L., and Edge, Jerry T., Windsor Professional Information, San Diego, 2004.

There is a greater in depth coverage of short term variable pay fore those interested in the fourth chapter in **Executive Compensation, The Professional's Guide**, Editors, Davis, Michael L., Edge, Jerry T., Windsor Publishers, 2004.