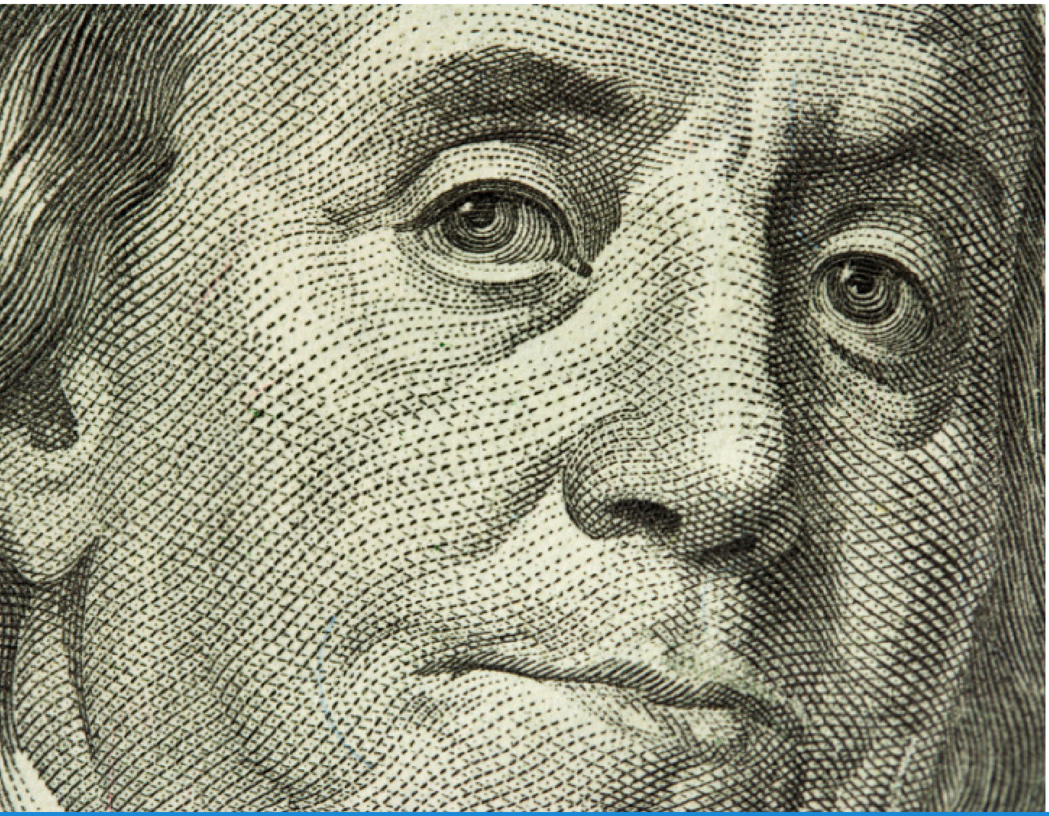
By Don Phin, Esq.

Do You Have a Compensation Philosophy?



" The greatest benefit is the one last remembered."

Barber's Book of 1,000 Proverbs

Over the years, I've been involved in many conversations around compensation including what to pay starting employees right up to how to incentivize salespersons and executives. Over that time, I have noticed that very few companies have a compensation philosophy. This means they don't look at compensation holistically, but as just one more activity to be accomplished. Here are thoughts that might go into your compensation philosophy.

1. **Will you pay below market, at market, or above market?** While pay is the most important factor why anyone works, once they feel a "fair days pay" is provided, it falls below fifth place in terms of being a motivating factor. A fair's day pay is determined by the marketplace, not you. In high turnover positions involving low skill sets, many employers feel it's in their best interest to pay minimum wage and no more. The challenge with this approach is when you pay peanuts, you get monkeys.

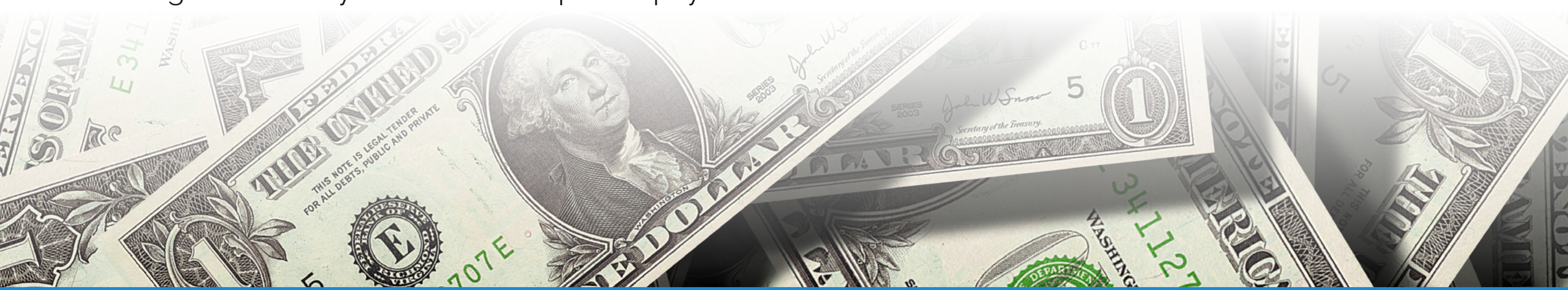
   Companies like In-N-Out Hamburger and Costco believe there is a return on higher than market entry-level wages. I know from personal experience that both companies have low turnover ratios compared to the rest of the fast food and retail industry. Their employers provide amazing customer service, and I love buying from them. I can't say this about many other companies in the fast food and retail industry.

   At some point, you lose the marginal utility of paying above market rate. My spidey senses tell me that's around 15%. If an employee is solely motivated by how much money they can make for themselves, I would rather look elsewhere. In my experience, those people come with much drama. Make sure that the wages of longtime employees stay in alignment with your market rate philosophy.

   One of the worst things that can happen is having to hire a new employee at a higher rate than what you are paying existing employees, because the market has changed and you didn't keep pace. This is a quick way of disengaging ling-term employees. No matter the size of your company, do a market rate review of all positions annually.

2. **Are the compensation levels sustainable?** I have seen entrepreneurs offer very large commission structures hoping to accelerate their business only to find that doing so drains cash out of the system. Dr. Deming reminded us that if you want to build a highly profitable company, every new dollar earned has to be earned more efficiently than the previous dollars. If that doesn't happen, you run out of cash.

3. **What are you trying to incentivize with any bonus or commission structures?** Is it individual performance, team-based performance, department-wide or companywide? How do people get their work done? Is it a call center where everybody's day is working on an island? Or is there a project team that must cooperate with each other? You would use different incentives in each situation to drive performance. [Send me an email and I'll send you my report on Sales Commission Agreements.]



4. **Watch the Cobra Effect with any incentives.** Back in Colonial India, the British were concerned that Bombay had far too many cobras running around. So in their effort to clean things up, they created an incentive to pay for any cobra tails turned in. Initially, they noticed a decrease in the cobra population. However, weeks later, the cobras were back and there seemed more than ever before.

   As it turns out, some enterprising farmers decided they would grow cobras simply to cut off their tails and collect the reward. When the British learned of the scheme, they eliminated the incentive. The farmers, who now had very unprofitable cobras they had to feed simply turned them loose making the cobra problem worse than ever. Hence, the "Cobra Effect". An example of the Cobra Effect is where quotas are benchmarked on a 90 days basis. Data will show many of the sales during the last two weeks of that quarter are unprofitable and simply made to reach quota levels.

5. **Compensation structures –** For several years, I helped advise network marketing companies. One thing I found most interesting about their compensation structures is that their "upline" associates could not get a raise unless all the people they brought into the organization got one first. They lived off the override. What if that same philosophy was required of our managers? What if a manager wasn't entitled to get a raise until he or she could justify the people they manage getting one first? As it does in a network marketing industry, it drives incentive down to help people perform.

6. **Watch it about internal competitions unless they are truly for fun reasons.** Years ago, I was influenced by the book by Alfie Kohn called the Case Against Competition. Competitions tend to produce more losers than winners. At one client, the salesperson won a winner take all trip to Hawaii for three years in a row. How much of her best practices do you think she will share with others, at the risk of losing her trip to Hawaii? Better to incentivize her to mentor the other salespeople and obtain an override percentage of their improvement. With those extra dollars, she can go to Hawaii or any place else she feels like.

7. **How do you structure executive compensation to avoid tax consequences?** Whether it's deferred income or other vehicles, tax considerations should be involved when compensating highly paid executives. Deferred compensation can also be a retention tool.

8. **What mixture of discretionary versus nondiscretionary bonuses will you use?** When I had my little company, I loved handing my employees $20 bills when "I caught them doing something well." They loved it too. That's an example of a discretionary award. A nondiscretionary award is formulaic, similar to a commission arrangement. Only, it doesn't involve sales. If somebody or some team or some goal is met, that employee gets that bonus. It is contractual. Depending on circumstances, you want to tweak your bonus distribution between the discretionary and nondiscretionary incentives.

9. **What's the competition paying?** I've seen hospitals raise their nurse pay by 50 cents and

attract several nurses from the nearby hospital. Six months later, the other hospital then raises its rates by $1, and an equivalent amount of nurses come back.

Competition is broader than just simply what's going on in your industry. Often, fast food, transportation, retail, and other industries are all drawing from the same labor pools. The vast majority of these workers are simply happy to have a good job. No matter what it is. An extra buck or two – bonus!

10. **How rich do you want your benefits and perks to be?** Platinum level health plans benefit the least healthy portion of your workforce. There is little responsibility to control cost, and if they do so, there is little reward for that. Elaborate benefit packages are also more important to older workers, especially if they have families than they are to most entry-level employees.

    I am a big fan of how my friend, Dennis Kelly, advises companies on structuring their health insurance plans to use the power of shared responsibility and shared reward to drive down cost.

    I also know that the number one factor in driving down healthcare costs are to have highly productive workers.

11. **Factor in lost opportunity costs** – squabbling over the last $5,000 in salary may not be worth the $50,000 in lost opportunity cost it generates.

12. **Think in terms of the lifetime value of an employee.** Just as you should think about the lifetime value of a customer or client when creating marketing and sales budgets, be thinking about the lifetime value of an employee when creating recruiting and retention budgets.

13. **Don't make the mistake of paying people $80 per hour to do $40 per hour work.** All employees have a wide spectrum of work they do in terms of the specific value of any one task. Those low-value administrative tasks that can be done at a lower wage rate should be taken away from that person either through automation, delegation, elimination, etc. Compensate your employees to work in their highest and best use. Many employees are not bothered about getting paid $80 an hour do to $40 an hour work they can do in their sleep, without making a mistake, and gives them a mental break during the day. Heck, they might even check in with Facebook simultaneously!

    When I built my company, I didn't give me or my employees the choice to do low value work. We were constantly shedding tasks so we could increase our productivity. You want to cascade responsibilities down to their lowest common denominator so it looks like a Christmas tree. Then pay accordingly.

14. **Make sure you are paying equal pay.** Since I'm an employment lawyer by trade, I can't ignore the reality of this challenge. Stay on the right side of the law not just with equal pay but also wage and hour and similar compensation obligations. Part of your compensation philosophy should be to make sure you comply with the myriad of employment compensation laws.

15. Last, below is a checklist of factors to consider:

External Factors

- ❑ Availability of talent
- ❑ Competitive pressures
- ❑ Economy
- ❑ Industry
- ❑ Locations
- ❑ Regulation
- ❑ Technology

Company Goals

- ❑ Attraction + retention
- ❑ Branding
- ❑ Competitive pay
- ❑ Compliance
- ❑ Drive performance
- ❑ Drive profitability
- ❑ Flexibility
- ❑ Pay equity
- ❑ Transparency

Internal Factors

- ❑ Business strategies
- ❑ Employee sourcing abilities
- ❑ Financial health
- ❑ Growth opportunities
- ❑ Legal structure
- ❑ Non-financial motivators
- ❑ Size of company
- ❑ Stakeholder inputs

Employee Factors

- ❑ Experience
- ❑ Potential
- ❑ Productivity
- ❑ Responsibility
- ❑ Tenure
- ❑ Unique skills
- ❑ Value

About Don Phin, Esq.

Don has been a California employment practices attorney since 1983. He litigated employment and business cases for 17 years and quit once he figured out that nobody wins a lawsuit.

Since leaving litigation, he has written numerous books and presented more than 600 times to executives nation-wide.

Don was the founder and President of HR That Works, used by 3,500 companies and acquired by ThinkHR in January of 2014. He then worked at ThinkHR for two years as a V.P.

Now in his "wisdom sharing years," Don loves coaching executives and investigates challenging workplace problems. He continues to inspire with his speaking and training.

If you would like to discuss your compensation philosophy please give a call or send an email! All the best, Don

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