

THE  
COMPENSATION  
HANDBOOK

FIFTH EDITION

A STATE-OF-THE-ART  
GUIDE TO  
COMPENSATION  
STRATEGY AND DESIGN

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## TOTAL REWARDS STRATEGY

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**E**VERY ORGANIZATION WANTS TO ATTRACT, retain, and motivate employees. Many think that this is the primary purpose of the total compensation and reward programs. These companies then define their compensation strategy as being at “X” percentile in their industry, with the belief that this will enable them to attract and retain desired talent; motivation is achieved by the belief that their “pay-for-performance” program works. It would be interesting to determine if other systems within the organization are viewed in such a simple manner.

Recent changes in the regulations for disclosure of executive compensation require public companies to describe their compensation philosophy in detail. In the past, boards of directors (and executives as well) would use boilerplate statements to describe their programs in general, vague terms that provided little insight for the reader. This change in regulation has many compensation committees, boards, executive managers and human resource directors looking for verbiage that does not require them to invest too much effort or divulge too much information. Some companies are using this situation to examine their fundamental philosophy and requirements, while others are missing a critical opportunity.

While one can appreciate the need to keep specific compensation information confidential, the inability to define the firm’s basic philosophy in meaningful and

substantial ways often leads to haphazard decisions and undermines the confidence of shareholders and employees alike.

**Consider.** What would happen if your marketing department presented to executive management a strategy that positioned a new key product to be the same as your competitors—in the price, features, and value proposition? How would your executives respond? Then, why does a company seek to make their compensation and reward programs “the same” as other firms in the market? Is it better for your compensation programs to conform to the market or be distinctive?

Why should someone come to work for your company, remain with your company, or buy your company’s products, services or stock? What is different about your organization that would compel one to work for your company? Furthermore, how much money does your organization spend on compensation? What is compensation as a percentage of revenues or operating income? Does the company apply the same level of strategic and operational thought to expenditures for compensation as it does to other major expenditures or investments? When an organization spends (or invests) its dollars, it should know what it is paying for and seek to maximize the “value” from these expenditures. Addressing these issues is the value a reward strategy provides to an organization.

## PURPOSE OF A TOTAL REWARD STRATEGY

To understand what a Total Reward strategy is, let us start with a definition. “Total Rewards” are those policies, programs, and practices that provide employees of a company (or organization) with something of value in return for their contributions to the mission and goals of the organization. These can include salary and variable cash compensation programs, employee benefits and services, stock options and other equity awards, and special recognition, promotions, etc. Therefore, the *purpose* of a Total Rewards strategy is to provide the objectives, guidelines, and principles necessary to design and operate the company’s reward programs consistent with its core requirements.

Fundamentally, this means that the reward strategy should:

- Reinforce the core mission, values, and critical success factors of the company in terms that reflect the role of reward programs and practices
- Define what are (or will be) the key elements that will create a strong competitive advantage for the company in the marketplace for talent
- Provide sufficient clarity and guidance to key decision makers so they can assess the effectiveness of current programs and practices, and determine what actions are needed to improve their effectiveness
- Answer “why” a particular program is designed or functions in a particular manner

We have found that, while the words may appear similar from one organization to another, the real value is the meaning the reward strategy has to the members of the organization. The words become reality when they are effectively translated into action through policies, programs (or systems) and practices. The result is simple—an effective framework to allocate resources and create strong capabilities to influence desired behaviors (i.e., performance) of people.

## KEY ELEMENTS OF THE TOTAL REWARD STRATEGY

Developing a reward strategy that meets these requirements is a real challenge for many organizations. An increasing number of companies realize that their performance is truly based on the talents and actions of their people, and that these programs in fact exert significant influence on behaviors by the messages they send, the opportunities they provide, and the needs they meet for the workforce. An organization’s culture is not shaped by its stated values and communication, but by what and how *actions are encouraged, rewarded, and punished*. A reward strategy translates a company’s strategy and core values into policies, programs, and practices that *directly* influence the performance of people.

The reward strategy statement needs to include these elements:

1. Establish the context for the total reward philosophy, especially if the organization is facing particular challenges or has implemented a fundamental change in the way programs have been managed in the past
2. Provide a unifying statement of philosophy (or principles) that connects reward programs to the core mission, strategy, and values of the organization
3. Express the importance of these programs to the company’s ability to attract and retain people, as well as develop talent and reward desired performance
4. Define the primary programs and their basic purpose or focus, including base salaries, variable cash compensation and equity participation, employee benefits and services, and workplace opportunities for development, careers and recognition, etc.
5. Identify the primary drivers of these programs—the competition for talent, corporate/unit/individual performance, the infrastructure to make sound decisions, desired types of behaviors and support for strategic change

A Total Reward strategy is therefore a statement that sets the stage for specific policies and programs, and defines the requirements and impact desired from them. Here is an example:

IBM has significantly reoriented its reward strategy, focusing more of its compensation investment on programs that recognize results than on those that reflect only tenure. Today, IBM’s overall compensation strategy is designed to deliver market-based, performance driven pay in all segments of our business portfolio, and to reward appropriately our highest contributors. We do this through a

combination of base salaries and variable performance-driven bonuses. Our goal is nothing less than to sustain and renew the highest performing, most cost effective culture in business. To do that, we seek to hire, measure and reward the individuals who create that culture every day.<sup>1</sup>

### DETERMINE THE RIGHT REWARD STRATEGY

Carl Sagan once said that, in order to make an apple pie, we must first create the universe. Without going into this level of design, the reward strategy is fundamentally based on the strategic and organizational requirements the organization has for its people. This process involves addressing four primary areas. As these are understood, the task of developing a reward strategy that makes sense and is effective for the organization becomes significantly easier. These areas are shown in Figure 3.1.

#### Define the Organization's Philosophy

To develop the total rewards strategy, the first stage is to understand the organization's business model, vision, and strategy as well as its critical success factors. One needs to know the leadership philosophy, values, and desired culture, whether or not it is written into a formal document. The following questions may be helpful in defining this philosophy:

- Is the organization focused on broad markets or specific niches or market segments?
- Is the core competence of the company stronger in creating innovative solutions to meet customer's needs or in providing low-cost, efficient services to customers?
- Is growth achieved through organic, market expansion or through acquisitions, joint ventures, and business networks?

FIGURE 3.1 Defining the Total Reward strategy



- Do the firm's leaders have a particular philosophy, values, and operating principles by which they lead the organization, and seek to create its position in the marketplace?
- Is the organization facing pressures to adapt to changing market conditions or transform itself into a different business model or marketing strategy?

#### Examine the Organizational Structure *plus* its Guiding Principles

The response to these questions provides the context and frames the challenges facing the organization from both a talent management and performance perspective. This information should provide insights on why the organization is structured and operates as it does, as well as the types of rewards that will be most effective in supporting the long-term strategy of the organization.

The next stage is to articulate how the firm is organized to implement the strategy and operate within the constructs of the firm's values and leadership philosophy. This goes beyond examining the structure of the organization (i.e., who reports to whom), and identifies the guiding principles by which the organization functions.

Questions that may be important to understand this stage are:

- Is the company organized around markets (i.e., geographic, industry, or customers), functions (i.e., sales, operations, engineering, etc.) or independent business units? Why?
- Does the culture of the organization emphasize collaboration and teamwork or individual initiative and accountability? Does it emphasize short-term, concrete results or long-term development? Does it foster transactions or long-term relationships? How and why?
- Are decisions made in a highly centralized, well-controlled manner, in a highly decentralized, entrepreneurial manner, or in a cross-functional, collaborative manner? Are there differences in how specific types of decisions are made (e.g., financial, operational, customer, capital investment, etc.)? Why?

This information is important to forming a reward strategy because it defines how much flexibility various reward programs will foster as well as the process for making decisions related to goal setting, performance assessments, staffing levels, and hiring agreements.

#### Determine Employee Groups with Unique Reward Requirements

The third stage is then to define the groups of employees where reward policies or programs should be distinct or specifically tailored to unique requirements. These groups may be by business unit, function (e.g., sales, engineering, manufacturing, corporate services), level (e.g., executives, senior management, managers and supervisors, professional and technical contributors, administrative and operational

employees), or where “special attention” is needed (e.g., high potentials, key contributors, technical/product specialists, diversity groups, recent acquisition). By identifying specific groups of employees and understanding what they may want or need as well as what the organization needs from them, the reward strategy becomes more pragmatic and grounded in the realities of the organization.

**Create Specific Reward Policies**

The next stage is to identify the specific reward policies, programs (or systems) and practices the organization will employ to achieve short- and long-term requirements. While this can be defined for specific groups (based on the previous stage), it can also be framed for the entire organization. We have found that it is useful to categorize reward programs according to dimensions that reflect their inherent function and impact. To be more specific, there are reward programs that are:

- Available to virtually everyone because they are employed by the organization (or for a specific level or group within the organization). These programs provide a foundation for the employment relationship.
- Based on performance or meeting other requirements of individuals or groups to which they belong. In these types of programs not everyone receives these rewards, and the amount depends on many factors related to the design of the specifications of the particular policy or program.

Furthermore, there are programs that are:

- clearly compensation based (e.g., salaries, variable cash compensation, equity based plans, etc.), and
- meet the personal needs of individuals (e.g., employee benefits, services, recognition award programs, promotions, career opportunities, training and development, etc.).

These two sets of dimensions provide a simple framework for understanding and organizing reward programs according to their primary function or inherent purpose. Figure 3.2 shows this framework and illustrates the types of reward programs that correspond to these dimensions.<sup>2</sup>

As the organization conducts its own “inventory” of reward programs using this framework, it creates a portfolio of rewards that can be analyzed and refined to specific employee groups. People within an organization often have different needs and values; this “portfolio approach” enables the organization to target specific programs to address the unique needs and expectations of population segments within their organization, similar to how a company targets products and services to specific market segments. Using this framework, the organization can develop a strategy that is consistent with its strategic objectives and the requirements it has for key groups within the organization.

**FIGURE 3.2 Compensation strategy and performance reward programs**  
*Foundation Programs:*                      *Performance Rewards:*

<i>Total Compensation</i>	<b>SALARY &amp; WAGES</b>	<b>CASH &amp; EQUITY BASED VARIABLE PAY</b>
	<ul style="list-style-type: none"> <li>• Job or market based pay</li> <li>• Competency based pay</li> <li>• Salary ranges/Broad bands</li> <li>• Career path based pay</li> <li>• Geographic differentials</li> <li>• Merit/Market increases</li> </ul>	<ul style="list-style-type: none"> <li>• Individual variable pay</li> <li>• Team/unit variable pay</li> <li>• Company profit sharing</li> <li>• Stock options/restricted</li> <li>• Long-term cash or phantom share plans</li> </ul>
<i>Workplace Opportunities</i>	<b>EMPLOYEE BENEFITS &amp; SERVICES</b>	<b>DEVELOPMENT &amp; RECOGNITION</b>
	<ul style="list-style-type: none"> <li>• Health and life insurance</li> <li>• Retirement and investment</li> <li>• Disability and long-term care</li> <li>• Training and education</li> <li>• Company events/parties</li> <li>• Employee discounts/services</li> </ul>	<ul style="list-style-type: none"> <li>• Public/private recognition</li> <li>• Verbal/informal recognition</li> <li>• Personal item rewards</li> <li>• Special award bonuses (\$)</li> <li>• Promotions</li> <li>• Professional development</li> </ul>

**Develop the Reward Strategy**

Once the organization has identified its formal and primary informal reward programs and practices, the final stage is to address several important questions to develop the reward strategy.

1. What current programs is the organization primarily using? Which ones are most important to the overall organization and why?
2. How competitive are these programs in the external marketplace for talent? Where does the company need to lead or be distinctive in the market and where does it need to follow or meet basic levels? Why?
3. Which of these programs are the most important to specific groups of employees and why?
4. Where (among the types of programs or services) does the organization spend the most money? Where does it spend the most time and effort, and why?
5. Which of these programs are the most and least effective in supporting the mission, strategy and culture of the organization? Why?

Based on this information and insights, the company can develop a strategically based Total Rewards framework that is consistent with its core mission,

business, and strategy. The statement of requirements for each program (or type of program) should include the following elements:

- The purpose and key objectives of the specific reward program
- The most important requirements for these programs to be successful
- The marketplace and desired position the program needs to achieve in order to be meaningful to the relevant individuals
- How these programs will directly support the needs of the organization and the individual.

These strategy statements not only define the purpose and requirements for specific programs, they reinforce the universal principles necessary for achieving alignment with a firm's core strategy and leadership philosophy. Therefore, the corporate philosophy captures the primary themes that are important to the entire enterprise, while the reward strategy defines the requirements for key programs. The effective implementation of its policies, programs, and practices will significantly strengthen the firm's competitive advantage and market leadership.

Consider another example from a rapidly growing medical devices company:

The purpose of our total reward programs and practices is to provide the company with strong competitive advantages to attract, retain and effectively utilize the talent we need to achieve sustained market leadership.

The primary principles for all our reward programs are to:

- Strengthen our ability to drive desired business results
- Support the growth of our business globally
- Expand the capabilities of our people, from both attraction of new talent and developing current talent, to sustain high performance
- Make effective decisions in utilize our people and our resources to the benefit of the company, the people we employ and the people we serve.

This company went on to define the primary purpose of each category of rewards as follows:

- **Base Pay Programs:** They provide the structure and pay guidelines for the company to attract, retain and reinforce the development of personal capabilities. The pay structure will enable us to be competitive with the median of our key market, both globally and locally, where the grade level reflects one's job scope and responsibilities and the pay range reflects the external market for talent. Pay increases are based on both the growth of responsibilities and competencies and the demonstration of these practices in what and how results are achieved.

- **Variable Pay Programs:** We will utilize a weighted blend of individual, team and key business unit goals to provide clear performance expectations, encourage achievement and reward results. Our cash-based variable pay will focus on those results that provide critical contributions to and achievement of key annual business objectives tied to the corporation's overall objectives; our equity-based awards will reward those who make significant contributions to results that build the long-term value of the corporation—to our shareholders and our customers.
- **Employee Benefits and Services:** These are a variety of programs, services and opportunities for individuals that provide needed security to one's personal obligations and ability to receive highly valued benefits at a lower cost because of our combined participation. Because we as a company value our differences, individuals will have the greatest flexibility possible in selecting those that are most meaningful and important to oneself and one's family.
- **Performance Recognition:** In order to recognize individuals and teams who clearly made a difference to our customers and to our organization, we offer a wide variety of formal and support for informal appreciation programs. While these are often defined by the particular business unit within the company and provide awards that are personally meaningful to the individual, they each reinforce important values of the company—collaboration, commitment, responsiveness, integrity, respect, and performance.

The company uses the philosophy and principles implied by these descriptions as the framework for designing, managing and communicating their reward programs.

## APPLYING THE TOTAL REWARD STRATEGY

A Total Rewards strategy statement works because it enables the organization to make better decisions and focus actions on those areas that create a sustained competitive advantage. It facilitates an assessment of current programs and practices, and identifies where the organization may need to invest resources. So, the reward strategy goes beyond just defining compensation in reference to an external marketplace and strategically positions these programs. For many organizations "how" programs work is often more important than "how much" (in terms of dollars) they provide to employees. Understanding the marketplace and your competitive position is critical to a sound reward strategy.

Once this statement of philosophy and strategy has been defined and applied to existing programs, the challenge of communication will need to be addressed. There are several applications for this information:

- For meeting SEC *disclosure requirements* for executive compensation, one should select those statements that communicate key messages to the broad audience of investors, employees, and interested parties.

- For *recruiting*, key messages can again be selected and integrated into the materials and initiatives to attract desired talent to the organization; they should support the firm's overall staffing plans and initiatives.
- For *retention* of critical talent, this process has identified the specific groups, their needs as well as the organization's requirements, and the reward strategy can now effectively assesses whether it provides sufficient rewards and opportunities to retain these individuals. The company can create mechanisms to cost-effectively retain this talent.
- For *performance*, the reward strategy can identify the performance metrics that can and should be integrated with reward programs for specific groups of employees—executives, sales, operational, and service employees. Through the application of the guidelines, principles, and messages of the reward strategy, the organization gains a return on its investment in both the development of these statements and the dollars invested through its specific performance-based compensation, benefits and rewards.

The process and the outcomes should move an organization to a new level in its understanding, use, and value received from its reward programs. Rather than imitating what other firms have done in the past, or providing superficial statements that ultimately are not translated into decisions or actions (thereby undermining leadership credibility), a strong reward strategy shapes decisions. This will strengthen the effectiveness of these programs and help build a new, more significant, and important relationship between an organization and its people. By so doing, the organization is more capable of meeting the challenges of a complex marketplace and fulfilling its mission. It is just that simple, and that important.

#### END NOTES

1. IBM SEC Filing 14A, 2006.
2. Thomas B. Wilson, *Innovative Reward Systems for the Changing Workplace*, 2nd edn, New York: McGraw-Hill, 2003.