THE FAMILY BUSINESS CONSULTING GROUP

Developing a Philosophy of Compensation

By: Craig Aronoff, Stephen McClure and John Ward
The Family Business Consulting Group, Inc.

A good compensation plan should provide incentives so that everybody involved in the business works for what is best for all. To accomplish that, the plan must reflect the business's core philosophy.

A philosophy of compensation is a summation of the values, goals and principles that guide all decisions about salary, benefits and perks. It provides a framework that relieves decision makers of the burden of developing each compensation package individually. Building and describing this framework can force business owners to assess their most fundamental goals.

A central question is how the company remains competitive. Some companies, for instance, stress increasing shareholder value. This emphasis on profit maximization underlies a belief in hiring and retaining people at relatively low pay, charging customers higher prices and keeping supplier costs low, resulting in the best possible returns to shareholders.

Others take an employee-driven approach that focuses on creating the best possible opportunities and environment for employees. This reasoning holds that if employees are encouraged through attractive pay, benefits and perks to perform at their highest potential, stockholders, customers and other constituents will benefit from improved productivity, efficiency and quality.

Other businesses put service to the customer first on the list. This reasoning holds that if customers are attracted and retained through low-priced, high-quality products, the business will grow, creating new jobs for employees and higher returns for shareholders.

Most business owners would agree to some extent with all of these priorities. The question is usually one of emphasis—which of these goals do strategists stress most often, and which are the most central to their mission? The answer can strongly influence how compensation philosophy is determined and articulated.

Another philosophical issue that impacts compensation is the owners' attitude toward risk. Those who believe that the risk and the rewards accrue to the owners tend to focus compensation on a relatively fixed salary. Those who believe that employees should participate in business risk may make salary lower and variable bonuses a larger part of total pay.

Another central issue is determining how jobs are valued. The backbone of compensation policy might be, for instance, that everyone is paid according to the market value of the job performed. Other family businesses may add "qualitative" criteria, such as the leadership, communication or analytical abilities required to do a particular job well in a particular company. Still others may decide to pay family members equally, reflecting an attitude of "one for all and all for one."

Whatever the choices made on these issues, the fundamental requirement is that the compensation philosophy provide for a consistent, above-board approach to pay.

Should We Embrace a "Market" Approach?

To avoid problems, there is no substitute for paying people based on the size and difficulty of the job and in relation to comparable jobs at comparable companies. In other words the marketplace provides the basis for compensation policy and owners should make sure that everyone understands how pay is determined.

Market value is a fair and consistent guide to setting pay, and it is relatively easy to explain to employees and shareholders. Simply put, a market value philosophy means you pay an employee what it would cost you to hire someone else to do the job. Its objective basis reduces the potential for misunderstanding and manipulation. It gives family members and other employees a realistic view of the value of their work, and it drains negative emotion from sensitive family interactions over pay.

Yet "pay people what their job is worth" is easier to say than do. Some family businesses decide for good reason not to embrace a market value approach, and any business considering doing so for the first time should stop to consider the ramifications.

In some businesses, pay has been set on non-market criteria for a long time. Some family members and other loyal employees may have been increasingly overpaid over the years. Family members who have been relatively underpaid may not see any reason to stir up the issue and hurt people's feelings. The status quo may be acceptable, and introducing market data or consultants' appraisals that expose inequities may only open unnecessary wounds.

Before taking even preliminary steps to seek data or make comparisons with other businesses, the following questions should be considered:

- How has pay for family members been set in the past?
- Are there important reasons to change to a "market value" approach?
- If we do get objective data and it shows significant inequities, what will we do then?

These issues are especially important when the business is passing to a new generation of family members. During preparation for succession, members of the younger generation should meet to discuss the above questions and decide whether a change is needed.

The "market value" approach does have some advantages at this stage, at least until next-generation successors become substantial shareholders. If inequities in pay exist, they inevitably will come to light at some point as the next generation assumes leadership and ownership. If potential problems are not addressed early, they may become more painful and difficult to resolve later. In most cases, by the time that the successor generation is established in its careers, family businesses decide pay should be based on the market value of jobs.

But before determining the market value for jobs held by family members, consider and discuss what steps you want to take if market value and actual pay are very different—either higher or lower. A little preparation will make family members less likely to respond defensively or mount an attack once comparable pay data is received. They also will have an opportunity to provide hands-on job descriptions to assist data-gatherers, and may learn something about their own jobs in the process.

(This is an excerpt from *Family Business Compensation*, 2nd edition, Palgrave, ©2009)