



FUNDAMENTALS OF FAMILY BUSINESS COMPENSATION

Ernest A. Doud, Jr., CMC
Managing Partner
DoudHausnerVistar

NOTE: This is the first of a multi-part series on compensation for family businesses. Look for more on this subject in future editions of "Family Enterprise."

Introduction

Compensation is, at best, a difficult and highly emotional subject. Like it or not, one of the most prevalent measures of success used in our society is how much money one makes. In that atmosphere, even the most sound, well thought through compensation decisions made - and actions taken - by competent, responsible leaders and managers will not please everyone all the time. Moreover, this year's decisions and actions will be all but forgotten next year.

That challenge, however, is not an excuse for leaders and managers to throw up their hands and abrogate their responsibility for making sound compensation decisions. In the face of the complications mentioned above, a fair and equitable reward system designed around sound compensation philosophy can be a powerful motivational and retention tool. Conversely, a system built on top of a faulty philosophical base can be de-motivating to employees and disruptive to the business.

In family businesses the compensation design and management challenge is particularly acute when the family-based value of "equality" and presumptions of entitlement lock horns with the business-based values of "fairness," "equitability," and "differentiation." In such an atmosphere, implementing sound approached to compensation can take courage. However, we believe that if such principles are adopted and supported they will make an important contribution to business prosperity, family harmony and personal well being. Accordingly, they are worthy of your wholehearted and unanimous support.

How Compensation is Earned

There is an important distinction between how compensation is delivered to managers, and how it is delivered to owners. Managers and other employees are rewarded by compensation in various forms, and by benefit and perquisites. These rewards become operating expenses of the business.

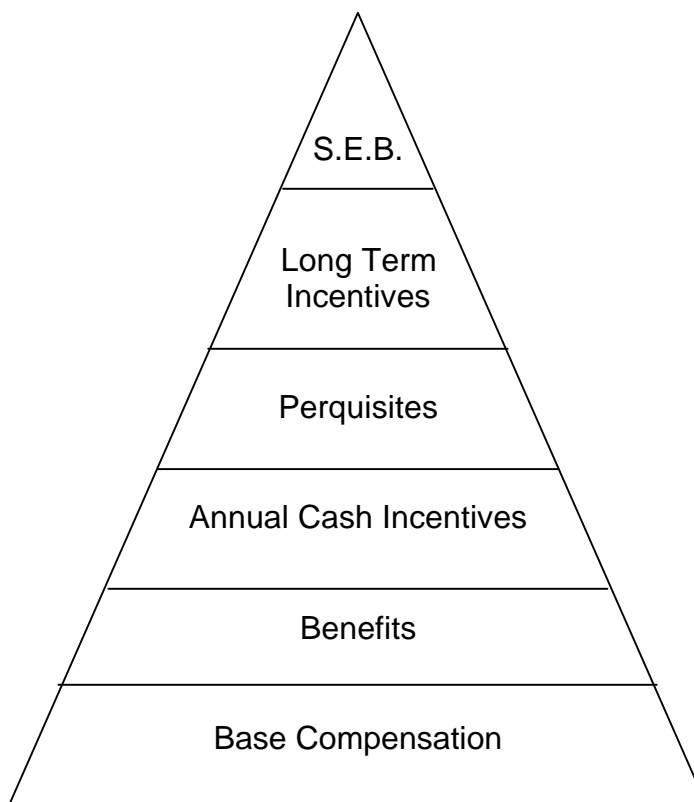
Owners are rewarded by "dividends." That word is in quotes because we know that for tax purposes family businesses often work hard to avoid dividends in the formal sense. Nonetheless, it is important to keep in mind that whatever the means of delivery, everything an owner receives by virtue of his/her ownership stake in the business is a

“dividend.” Dividends are the “left-overs.” They are available for distribution *after* operating expenses are paid and necessary reinvestment capital is provided for.

Employee compensation depends on job value and personal performance. Ownership dividends depend on business results and percentage of ownership.

The Compensation Pyramid

Effective compensation programs are built from the bottom, up. The construction sequence is illustrated in the following diagram. The pyramid shape is significant in that in most family businesses, going from the bottom up, each succeeding element represents a smaller percentage of total compensation. Sound design philosophy considerations for each element of the program are discussed beginning below the diagram.



Base Compensation

General Comments

Sound design principles begin with base compensation. It forms the base of the pyramid for a number of reasons:

1. It is the single most significant source of cash income for most (if not all) employees.

2. Participation in many benefit programs, and in incentive plans, is typically expressed as a percentage of base salary. Therefore, if base salaries are not “right,” an organization’s compensation program can be built on an unsound foundation and will lose much of its reward, motivational and retention value.

Setting Base Compensation Opportunities

There are two considerations to be balanced when establishing a range of base salary opportunities for each position in the organization:

1. External Competitiveness: Each position has a value range relative to other similar positions in the appropriate employment area, e.g. national, regional, local. The range for any job in any organization must be set to allow you to compete effectively for qualified candidates for that job. Set it too low and you will get what you pay for. Set it too high, and you will overspend on compensation – thereby denying the organization needed working capital and/or downgrading the owners’ return on their investment.
2. Internal Comparability: Each position contributes in different measure and in different ways to the business. Some supervise more people than others (line responsibility). Some have greater policy setting authority than others (functional responsibility). Some have greater decision authority than others and – as a result – impact business performance more directly. Some require more experience and/or more “technical” knowledge than others. Understanding the relative “worth” of positions with the organization is essential to establishing the range of salary opportunity for each position.

Taking both external competitiveness and internal comparability into account enables management to fairly distinguish between salary opportunities provided to jobs a varying “worth.” Failure to make these distinctions will cause employees whose salary is set too low to become disaffected. Employees whose salary is set too high will become defensive. The typical net result is a dysfunctional, under-performing business.

*Look for more information about base compensation
in the next article in this series.*