
# IS PAY FOR PERFORMANCE REALLY WORTH THE EFFORT? Part 1

By: August Aquila and Coral Rice

What business leader today isn't being asked to exceed customer expectations in a climate of fear and economic downturn, to be forward-thinking and innovative, and to execute on the organization's vision and strategy but to do so with decreased resources? With so much on their minds, why would or should an overhaul of the organization's compensation systems become a high priority? Would a transition to a pay-for-performance compensation system really be worth the effort . . . especially when so much debate about pay-for-performance systems has transpired over the past several years?

In the 2006 Owner Compensation Survey1 conducted by the authors, 140 (36% of the 388 respondents) indicated that if they were to select a new compensation system, they would choose a pay-for-performance plan. Another 71 (18% of the 388 respondents) indicated they would select a formula method (one in which the firm uses algebraic formulae to determine income allocation). These statistics suggest to us that the move toward pay-for-performance is a move away from traditional entitlement or subjective systems.

## What is Pay for Performance?

Pay-for-performance is frequently referred to as merit pay or incentive pay. Regardless of what people may name it, pay-for-performance is paying or compensating an individual beyond their base pay or salary for accomplishing specific, agreed-upon measures of performance rather only for time worked, seniority and/or ownership.

In a structured pay-for-performance program or system, employees and owners are clear about and understand the relationship between performance and the incentive. This understanding is documented in a written agreement before the fact and is often called a win-win agreement (a term first coined by Dr. Stephen R. Covey in his bestseller, The 7 Habits of Highly Effective People). A win-win agreement is an informal contract between the firm and the individual that outlines expectations of the individual in order for him/her to earn a portion or all of the incentive pay for which they are (or

[1] The complete survey can be found in Compensation as a Strategic Asset: The New Paradigm by August Aquila and Coral Rice (New York: AICPA, 2007). Product Number 090493.

could be) eligible. More specifically, win-win agreements outline desired outcomes, guidelines about how the individual will accomplish these desired outcomes, resources that may be needed to support them in their accomplishment of these goals, how accountability will happen (often through tracking), and what the consequences (payout) will be.

What most people, employees and firm leadership, appreciate about documenting agreed-upon expectations is the lack of surprises by anyone at the end of the year. In most cases, pay-for-performance systems (unless there are design flaws) minimize favoritism as well. And yes, evaluation of subjective factors is possible, but generally small.

**With Pay-for-Performance, is All or a Portion of Compensation Tied to Performance?**

According to consulting experiences, we are finding that many accounting firms tie a percentage of total compensation to some type of performance. We've seen ranges from10% to 50%. In other industries, we've seen as much as 100% of compensation earned as incentive pay. In any case, true pay for performance is variable compensation that must be re-earned each year and typically is not reflected as a salary increase that permanently increases base salary.

**The Pay-for-Performance Process**

Let's assume a firm has developed and communicated its mission, vision and values as well as a strategy to help the firm realize the vision, and thus, achieve its mission. A pay-for-performance system goes hand-in-hand with (i.e., links to and supports) the strategic plan and is designed so that the behaviors needed to accomplish the strategy are promoted. You must note, however, that it is difficult, if not impossible, to implement a pay-for-performance plan without a strategic plan that includes key goals for the year and how you will measure accomplishment of those goals.

For example, Firm A is a mid-sized firm in a secondary market in the Midwest. One of its strategies for the current year to is develop new services. To accomplish this strategy in part, the tax department determines it will develop an estate planning practice with a team of competent professionals.

1. Firm Goal - develop new services over the next 12 months
    a. Tax Department Goal – develop a viable estate planning group in the next 12 months
    b. Tax Partner A Goals
        i. Client Development/Management
            1. Develop 24 prospects
        ii. Cross-sells to existing clients or sells to prospect
            Leadership
            1. Development viable estate planning practice by December 31, 20xx

2. Help estate planning team members achieve their goals

When developing a pay-for-performance system, as indicated earlier, the firm must determine the results it intends to measure and what actions are necessary to achieve those results. In the case above, firm leaders must meet with members of the tax department who will be involved in the estate planning initiative. For the initiative to be successful, what must the department head accomplish? What must other partners do? What must tax managers and tax staff members do? The answers to these questions serve as the foundation for a win-win agreement with each team member and for a win-win agreement between the firm and the tax department.

Most people recognize the above steps as a basic goal setting process . . . nothing new . . . so far! Certainly, when creating a pay-for-performance system, you follow these steps, but pay-for-performance brings an added dimension. Each person in the firm knows "up front" what he or she must do to be successful and how these actions impact the success of the team. In other words, they understand how their behavior is measured and rewarded as well as how the team is rewarded by accomplishing its goals. Bottom line . . . an effective pay-for-performance system measures both independent and interdependent accomplishment.

In addition, an effective pay-for-performance system rewards both character *and* competence. Think about character as living the firm's core values and competence as knowledge, skills and abilities in a variety of both hard skill and soft skill categories (e.g., client service, business development, technical skills, leadership, etc.). Simply put, an individual may have great skills and produce excellent results (e.g., high billings), but will not receive maximum pay-for-performance if they abuse team members, thus impacting employee satisfaction and even retention. On the flip side, an individual who is nice and that everyone loves working with, but lacks skill and doesn't have a track record of results will not receive maximum pay-for-performance either.

Soft skills that are often measured and evaluated include:

- Does the individual partner work well with others?
- Does the individual exhibit an attitude of teamwork and/or develop the team?
- Is the individual looked upon as a role model?
- Is the individual dedicated to lifelong learning and development?

After determining broad categories of competencies, specific behaviors can be determined for each role or position in the firm. In the next article we will discuss the pitfalls and benefits of a pay for performance system.

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