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Developing an Executive Compensation Philosophy



Terry Newth

MANAGING DIRECTOR



Robert James

MANAGING DIRECTOR

This is the first in a series covering Executive Compensation Essentials—a resource for every board, compensation committee, and management team.

A well-defined compensation philosophy is a key input for effective pay design. Not only does it serve as a basis for almost all compensation decisions, it is also a valuable tool for communicating—both internally and externally—a company's values and goals and how they translate into employee rewards. And despite their significance, compensation philosophies can be an overlooked component of compensation planning or they may only be quick, check-the-box exercises.

It is true that like mission statements, philosophy statements are somewhat abstract and developing (or updating) one forces companies to consider complex questions to which there may not be clear answers. This is never an easy task and it can be particularly challenging for companies operating under pressure and in fast-paced environments where there is real business risk and many other priorities to focus on. Nevertheless, a compensation philosophy is a key element for the organization's overall talent management strategy.

Breaking Down the Compensation Philosophy

In its simplest form, a compensation philosophy is a summary of an organization's guiding principles for its compensation program. If it is relevant and done well, it will be informed by a thorough and ongoing assessment of organizational culture, strategy, and human capital needs.

While structures of compensation philosophy vary across companies and industries, they generally address the following key goals:

1. Documents objectives for the compensation philosophy;
2. Defines appropriate competitive reference points;
3. Describes the roles of various elements of compensation;
4. Determines the relative emphasis of compensation elements;
5. Clarifies the relationship between people, pay programs, and company purpose/values; and
6. Outlines company-specific pay considerations.

Trends and best practices certainly create overlap in compensation philosophies across all industries, although it's the subtle differences between companies within industries that can create competitive advantage. Taking time to carefully consider each of the items above is critical in the development process and, once defined, each item should translate and manifest itself in the overall compensation design.

Leveraging this Framework to Develop or Diagnose your Compensation Philosophy

Below, we present each component of a compensation philosophy and suggest key questions for companies to consider as they develop their policies. The resulting compensation philosophy outcomes illustrate how responses can translate into actionable items to drive compensation design.

Framework for Developing a Compensation Philosophy

Goal	Questions to Consider	Compensation Philosophy Outcomes
Documents objectives for compensation philosophy	▪ What is the ultimate purpose of the compensation program? ▪ What key objectives do we want our compensation programs to achieve? ▪ How are we using compensation to support our mission and strategic objectives?	▪ Objectives that are centered around attraction, retention, motivation, and shareholder alignment ▪ Additional objectives that serve to bolster culture (e.g., teamwork, mission, purpose, stakeholder alignment, etc.)

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Goal	Questions to Consider	Compensation Philosophy Outcomes
Defines appropriate competitive reference points	▪ To whom do we compare ourselves within the marketplace? ▪ Which business and talent criteria are most relevant for developing comparables? ▪ Does it differ based on level or function? ▪ Where should pay levels be set in relation to the competitive market? ▪ How should the pay positioning of elements of total compensation be differentiated?	▪ A peer group of comparator companies, selected based on industry, size, business, and mission similarities ▪ An articulated strategy around benchmarking approach at all levels that takes into consideration relevant labor markets ▪ Compensation reference points that serve as a guide in developing pay structures and guidelines
Describes the roles of various elements of compensation	▪ What role does each element of pay play in achieving our stated objectives? ▪ What different behaviors do our short- and long-term programs incentivize?	▪ An articulation of the purpose of each element of pay and how each element aligns with stated objectives ▪ Communicates the purpose of each component of the pay program
Determines the relative emphasis of compensation elements	▪ What is the relative emphasis of each element of pay (e.g., base salary, incentive pay)? ▪ What is the relative emphasis of each type of compensation component (e.g., fixed versus variable, short-term vs. long-term incentives)?	▪ Stated position on the priority of compensation elements in terms of the portion of overall compensation that they represent ▪ Communicates the priority of each compensation objective

Goal	Questions to Consider	Compensation Philosophy Outcomes
Clarifies relationship between people, pay programs, and company purpose/values	▪ How does our compensation program tie to our purpose/mission? ▪ What are the critical competencies that we look for in employees? ▪ Do these competencies support our key values (e.g., integrity, respect, etc.)?	▪ Ensures that the compensation philosophy and its underlying objectives and statements tie back to the company's mission, purpose, and values ▪ Provides continual communication of the things that matter for the organization
Company-specific pay considerations	▪ What factors are unique to us which should be considered when making pay decisions? ▪ What processes can we put in place that are consistent and defensible? ▪ Under what circumstances should we update/reevaluate these processes?	▪ Articulates how compensation decisions are made ▪ Sets up when the process should be reviewed for appropriateness ▪ Provides further opportunity to tie process and decisions back to culture, mission, purpose, and key objectives

Ongoing Assessment

Once the compensation philosophy has been developed and its principles are reflected in the pay program design, it's important for companies to conduct ongoing annual reviews to ensure that it remains relevant and that it's resulting in the desired outcomes. Below are a few examples of key compensation program objectives, and potential analyses that can be used to demonstrate whether the company is achieving its desired goals. There are also various tools that can assist in the monitoring process and diagnose potential issues.

Guide for Annual Compensation Philosophy Assessment

Key Objective	Potential Analyses

Attraction of key talent that can help drive our mission and purpose	▪ Review of compensation ranges to ensure competitiveness ▪ Review of compensation design to evaluate competitiveness and isolate differentiated design used in recruiting ▪ Human capital metrics (e.g., top candidate acceptance rate, etc.)
Retention of proven talent	▪ Review of individual compensation arrangements to understand competitiveness ▪ Review of the profile of current equity grants (unvested, equity value, leverage, vesting events)
Pay for performance	▪ Metric correlation analysis ▪ Pay-for-performance analysis ▪ Operating plan execution analysis
Alignment of employee and shareholder interests	▪ Equity wealth sensitivity analyses ▪ Share ownership guideline review

Of course, not every aspect of the compensation philosophy requires a specific quantitative analysis to confirm its effectiveness. In some instances, where there are inconsistencies between company culture and strategy, the lack of alignment between compensation philosophy and pay program design may be very apparent. (For example, if your strategy is to pay consistently below median, but you have retention problems.) Most important, however, is that companies routinely revisit the philosophy and that this process allows decision makers among the board and in the executive ranks to optimize pay programs accordingly.

In Summary

While they can be difficult to define, compensation philosophies provide a consistent framework for companies to work within by ensuring that all pay decisions are drawn from the same set of values. It is up to compensation committees and executive leadership to ensure the compensation philosophy reflects company culture and evolves with it over time.

About the Authors

Terry leads the Life Sciences practice and advises companies from venture-backed to multinational on executive compensation strategy, incentive design, governance/disclosure, and transaction-related arrangements.

Rob has 15 years experience in executive compensation and finance, specializing in life sciences and technology—especially emerging, high-growth companies navigating M&A and IPOs.

About Pearl Meyer

Pearl Meyer is the leading advisor to boards and senior management helping organizations build, develop, and reward great leadership teams that drive long-term success. Our strategy-driven compensation and leadership consulting services act as powerful catalysts for value creation and competitive advantage by addressing the critical links between people and outcomes. Our clients stand at the forefront of their industries and range from emerging high-growth, not-for-profit, and private organizations to the Fortune 500.