# Incentive compensation in family businesses

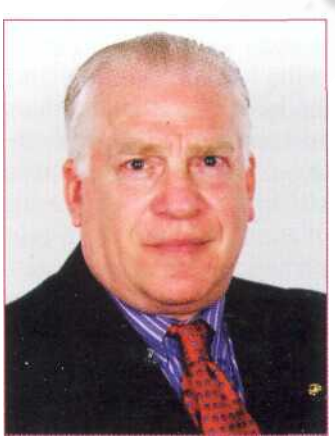
*There are ways to develop effective incentive plans without divulging sensitive financial information to non-family executives.*

**By Paul R. Dorf**

BETWEEN NOW AND THE YEAR 2015, family-owned businesses are going to have to learn to cope with at least three new realities. First, business in general will continue to get more competitive and faster paced, thereby requiring greater management skills. Next, the demand for highly qualified personnel will become even more acute than it is today, which will make it increasingly more difficult, and even more important, to retain key employees. Lastly, family issues will continue and, in some situations, will be exacerbated as the baton is passed from one generation to another, and leadership moves further away from the founder.

In many ways, family-owned and closely held businesses have been insulated from the demands placed on their public counterparts. They are not covered by the rigid requirements of the Sarbanes-Oxley Act and the regulations of the Securities and Exchange Commission, and many of the IRS regulations covering executive compensation have not affected privately held companies. The transparency demanded by stakeholders of publicly traded companies and among non-profits has eluded privately held firms, so "family secrets" will continue to remain sacred, at least for now.

However, to a great degree, public and private companies swim in the same labor pool. This means that family companies must provide compensation programs that contain similar, if not the same, components while offering comparable value within the overall compensation package. The typical components often sought by executives coming into privately held firms include the following:



**Paul R. Dorf, Ph.D.**, *is managing director of Compensation Resources Inc., compensation consultants in Upper Saddle River, N.J. (www.compensationresources.com).*

- **Competitive base salary:** Executives expect that their base salary will be commensurate with their experience. The base salary for a position is predicated on market value and takes into consideration the hierarchical level of the position; the industry; the size, scope and complexity of the job; and the geographic region.
- **Short-term incentive compensation:** Short-term incentives are the primary motivators and a key way of recognizing performance; they help ensure the executive's desire to contribute to the success of the organization. Executives want a clear link between their performance in achieving established goals and the payout at year-end. The design of effective short-term incentive plans is where many family-owned businesses struggle because they are reluctant to disclose financial data. Many of these companies forgo short-term compensation in favor of discretionary bonuses, in which the owner/manager makes a subjective determination of each bonus based on gut feeling, random statistical data or a Ouija board.
- **Long-term incentive compensation:** Executives who have worked in publicly traded companies typically are accustomed to receiving additional compensation in the form of long-term incentives, whether cash- or equity-based. In public companies, it's common to award stock as a long-term incentive. But most private company owners are not prepared to provide equity in their firms, even to their most critical management team members. They don't want "partners" and don't want to share control with outsiders. However, with relatively few fish in the talent pool, in order to attract and retain highly qualified executives, more and more family-owned *organizations are* considering adoption *of* some form of long-term incentives. This additional element of the compensation package allows them to compete for qualified executives, particularly those working in public companies, and to hold on to those they have. Often, the long-term incentives are

cash-based. They add another element to the compensation package and provide the company with the means to focus these executives' attention on the future, long-term success of the organization.

A number of variations of phantom stock programs can be developed. Each allows participants to share in the company's growth without the use of equity. It's important to note that in order to establish performance measures that drive success and ultimate payouts of long-term incentives, business owners must define goals and provide executives with targets they need to achieve in order to obtain the reward. Equity is often used as a measure of performance, but given the owner's goals, the awards are typically made in cash.

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In privately held businesses where the stock is not traded and therefore no ready market value exists, the company must obtain an annual valuation, which is expensive and problematic for the owners. Other non-equity measurements can be used that consider the increased growth of the company, as an absolute or against long-term pre-established objectives.

A combination of financial and operational objectives can be used for short-term incentives; for long-term incentive plans, generally only financial goals are used as performance targets.

## Ensuring a common focus

Since family members tend to be paid differently from non-family employees, to what degree should separate pay plans be developed for non-family executives? Considering the competitive market for qualified individuals, compensation programs should have provisions for the inclusion of family members. This will ensure that all managers have the same focus on achieving common goals, with a direct relationship to the level of rewards provided at the conclusion of the performance period.

In family-owned companies, the trend in compensation program design is moving away from subjective plans toward more formulaic annual and long-term incentives that are based on actual results achieved. The level of achievement is compared to established goals in order to determine the size of the award that has been earned. Every performance-based system requires that the organization have the ability to actually track and measure performance. This may seem elementary, but experience has shown that the finer points of goal setting and strategic planning are foreign to a lot of companies.

A reason often given by family-owned companies for not establishing performance measures is the owners' reluctance to share financial information with even their most senior executives. If they are afraid to share information, then how can an executive be expected to manage effectively?

Clearly, there is some information that family members do not want to make public, such as their own compensation and the amount of return to the shareholders. But if executives know what the target is, they are much more likely to know what to do in order to hit it! Specific performance objectives can be developed without divulging any sensitive information; this allows effective and true pay-for-performance programs to be developed. These can be in the form of quantitative objectives (e.g., increases in net income) or qualitative objectives (e.g., enhanced customer service).

## A delicate art

The success of incentive compensation plans is based on the effective use of a combination of financial, operational and individual objectives that are indicative of the participant's ability to affect results. Properly designed plans provide a direct correlation between performance and size of rewards.

Critical to this process is the family's commitment to providing ongoing feedback to non-family executives concerning their progress toward meeting their goals. Since detailed financial reports will not be shared with these individuals, it is imperative that family members provide some gauge of performance and success to these executives, in order to maintain focus and motivation.

Regardless of the composition of the total compensation package, performance metrics must be defined that motivate the executive to succeed. It is a delicate art, however, to define performance objective in relative, not absolute, terms. If the company is serious about retaining key management and competing in the marketplace, well-designed incentive plans with performance goals that focus executives on achieving the company's objectives will enhance its ability to keep these individuals over the long run. The organization must offer a competitive compensation package consisting of all three components: base salary, annual incentive and a longer-term plan. Each component of the compensation package should carry specific performance measures, which, when properly established and achieved, should ensure the success of the company.

Bottom line: After a swim in the talent pool, make sure to save room for SHRIMP: share the right information that is meaningful to performance. FB

Fonte: Family Business Agenda, ano 1, n. 1, p. 33-34, Autumn. 2007.