‘Knowledge Workers deserve Performance-Based Pay’

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Summary

Equitable business models will become more commonplace in the future. The business environment is and will continue to be complex and volatile. The costs of people to a business are significant and people performance is critical to business success. Pay that varies with employee performance is a desired element in business, from the view of all responsible stakeholders. The very real downside of job loss has not been equitably addressed for many employees. Variable pay seeks to rectify this risk vs. reward imbalance. Trust is required for such systems to work and therefore they must be built upon an open book reporting system.

Introduction

What has not changed in business structure, and will not change in the future, is the basic or generic business model. A business model is a representation or simulation of a particular business concept. To have business validity, a business model must yield a value proposition to customers. A value proposition is the provision of a product or service to a customer that sells for more than it costs. Ultimately, profit measures the effectiveness and sustainability of the value proposition. A business model deals with two key controllable inputs; capital and labour (people). A business model must also account for two key uncontrollable operating environment factors, government and competition. The third dimension to the flat model is time. The purpose of a business model is to demonstrate the validity of the value proposition.

As with any model, a business model does not prove the business will work, it merely demonstrates that it might work. A model attempts to incorporate many elements and variables, and can easily be defeated by the complexities of the real world. Business strategy is derived from the model, however, the excellent execution of strategy is important. Ultimately, in the real world, serendipity plays a role in business.

If one likens a business model to baking a cake, the finished cake is the value to the customer, the ingredients are capital and people, government and competition form the oven, and execution the heat. In reality, some ideas and businesses are 'half-baked'. A model tries to find the right mix of ingredients and the right chemistry to bake the cake. Models are generally non-unique; there is more than one way to bake a cake.

In order for companies in the geo-industry to enjoy business success in the future, they must shift towards equitable business models. I have defined 'equitable' business models, as those models in which the risks and rewards from the value proposition are fairly allocated to the input factors, capital and labour. **The need for equitable business models is driven by the realization that ‘knowledge’ workers have an overwhelmingly strong effect, through their performance, on the success of the business value proposition.** Among other factors driving the need for equitable business models are: the gradual separation (and therefore disconnection) of ownership and management in the last half of the 20th century, the economics of technology advances in the 1990's, the loss of the loyalty vs. security compact in the 1980's, and the accelerated change driving volatility of the economy in the last decade of the 20th century. These factors and their consequences have not been adequately factored into many current business models.

Theory

In order to better understand what an equitable business model encompasses, we should review some of the model elements particularly relevant to being equitable.

Capital

What does capital require in order to participate in a business? Capital, being fundamentally non-unique, requires a reward that is commensurate with the risk to which is exposed. Of course, perceptions of risk will differ, however, rules of thumb exist and prevail on a global basis. Money is capital, time is money. The time value of money drives capital's calculation of its return. Capital may be in the forms of equity money capital, borrowed money capital, and tangible items.

People

In order for people to participate in some way, such as employees, uniqueness prevails. Uniqueness of ability, skills, needs, wants, desires, life circumstance, and motivation. Surveys consistently show that money is at the bottom of the top-ten list of what people are concerned about in their work. Among top concerns are meaningful work, making a difference, career growth and learning, exciting work and challenge. An effective business model must somehow encompass the requirements of the people that the model requires in order for the business to function. Accordingly, compensation schemes and culture themes within business vary widely.

Government
For the privilege of providing the playing field, in the form of legal rules and property rights, the government claims whatever it wants. As a monopoly within a given country, it does not lose when a business fails, and makes money from the business and its employees as long as the business lives. If a business does well government makes even more, under the pay for performance system known as income tax.

Competition
The business playing field is highly influenced by competition. Therefore the business model must account for competition. There are few areas of business where selling price is not determined by competition, both directly and through substitute products or services. Unique business offerings are rare, and can theoretically set their own price, but in reality are governed by competition from substitutes and from fear of attracting competition - if the profits are too lucrative. Competition also influences employee compensation, attraction and retention.

Profit
Simply stated, profit is the revenue from the customer, less the expenses or the costs of the business, less income taxes. While some owners are not motivated to pursue profit for profits' sake, they must be motivated to pursue profit as the fuel to sustain their business model.

Balance
A conscious balancing of inputs within the model must occur because unlimited resources do not exist in this world. There is interplay between the balance of people and capital, and within each of people and capital. Obviously if people can be paid minimum wage, less capital is required to support the model. If the people required must earn a million dollars a year, more capital is required to support the model. Balancing the inputs determines whether the mix will prove to be valid.

Things Change
The model should be devised to accommodate changing circumstances. Flexible practices within the model enable the business to adapt to changed circumstance. Business models, or ways of conducting business, are based on facts and assumptions concerning the environment at the time the model was devised. These facts and assumptions are subject to change. These changes should in fact drive an adjustment to the business model, however, this often does not occur in a timely fashion, or at all. How the specific ingredients are mixed in the model and how quickly the mix can be changed determine whether the model can adapt and flex to real world events.

Equity
Equity (in an accountant's balance sheet terms), as opposed to 'equitable', is simply the assets of the business less the liabilities of the business. Equity, and the ability to generate increased equity through profit, is the true consequence of building value. Presumably the value generated results from the application of resources in the model, being capital and people. Capital contractually has very specific rights, risks, obligations and rewards for equity participation. But in the last few decades employees have not participated to a large degree in the risks and rewards of equity, primarily due to commodity types of labour and the 1950's-type notion of life-time employment security. That security no longer exists in the non-government arena and commodity type labour is less valued in Canada and the USA.

Compensation
Static compensation schemes pose a real problem for the business model. The extent to which the value proposition is successful is dependent on the relative performance of the people versus their business competitors. Future performance may be a known or predictable commodity at a burger flipping level, but at a professional or managerial/leader level it is very unpredictable.

In business there is never a 'one best' approach, due to the individuality of each customer and the constantly changing environment. Although we strive for simple models, complexity is the underlying reality. That stated however, I believe many business models fail because they do not adequately model people's pay versus their performance. The high percentage of total expenses that people costs occupy in business today, warrant creative thought. There are a number of tools and practices that can be used in business models to fairly pay for performance.

Discussion
The reality in some industries is to pay reflecting absolutely on performance. In the construction industry one does not generally see large companies with massive number of employees. Effectively subcontractors are the force that undertakes the work. Therefore you see everything from excavation through cribbing, framing, siding, roofing, plumbing, electrical, etc. handled by relatively small companies for every task required. Mostly, the pay for the job is a turnkey (fixed) amount. The result, not the effort, earns the pay. Those who are able to do the job faster, benefit from their abilities. Taking one's time or working a nontraditional schedule become the worker's choice. Poor workmanship or failing to adhere to timelines results in no further work. Those who excel at the value proposition win in two key ways, through dollars earned vs. time spent and through backlog or certainty in work. Another example of absolute pay for performance is the fully commissioned real-estate sales person. Private practice in many disciplines is directly pay for performance.

So, in the existing standard business model, we have the shareholders under a pay for performance plan, the government takes the upside but no downside with its pay for performance plan, but what's all too typically missing is significant pay for performance consequences for employees. Employees that can enable a range of performance (and that should arguably be every employee) should logically be paid, to a large degree, based on some combination of their individual, team, and company's performance. Those creating the value should logically have a significant vested interest in that value. This model-built flexibility is a competitive advantage in dealing with the cycles of business.

Methods of employee pay for performance are many, used individually and in combinations. Examples include commissions, bonuses, piece rates, turnkey compensation, variable pay, profit sharing, stock options, phantom stock, employee share ownership, incentives, prizes, royalties, etc. Historically many of these schemes have been rationalized as motivation tools, but their motivational effectiveness is arguable.

In one sense, a variable pay system merely makes the business reality, the employee reality. That missing link seems to have tripped up many businesses in recent years. Many big company employees have discovered massive grief, in the form of layoffs or bankruptcy. Fixed compensation systems are obsolete. The 5-15% bonuses fall in that arena. Limited bonus upside and capped bonuses no longer balance the downside of job loss. Rather than have employee perception of their employer's business purpose filtered through a fixed salary, direct compensation varying with business success and failure will provoke questions concerning strategy and execution, at the very least.

Needing to be addressed in any pay for performance situation is measurement in an objective way. And trust. All of us have worked for bosses where we were promised the world if we performed, and yet even with the performance goals met, the promise never quite worked out. We felt like the donkey moving towards the carrot held in position by a stick and a string. Trust is built one step at a time, but destroyed in an instant. Blind trust just doesn't fit into a business environment. So what foundation must be laid upon which the tower of trust can be built? My contention is that it is built on open book management. Open book management simply means that the data and information that will benefit people in doing their jobs is made easily available to them. In addition to making it available, usually the employee needs some training in how to interpret the information and thereby use it to help their individual, unit, and company performance.

Conclusions

Many of the variable pay schemes utilized within the geophysical industry today are merely gravy to the employee. These schemes inadequately reflect the risk to the employee in the business world of today. That reality is that without people performance there is no value generated. Unfortunately the attitude is to cut people rather than increase performance or revise the value proposition. Compensation models that place significant compensation at risk, and offset that risk with the reward on the upside will become more popular with employees, shareholders, lenders, and managers. Investors will question the motives of companies wherein the employees and managers do not have a significant vested interest in success.

In an equitable business model the reward from value generation is allocated appropriately to those factors creating that value. The corollary is that the downside risk is also allocated appropriately to those factors that could not create value. A benefit to such models is that in the good times all share and benefit and in the bad times the misery is shared. This built-in flexibility allows a business to react better to business cycles. The expensively built team does not need to be broken up or down-sized over a poor quarterly result.

If one were to create a business model today, starting with an entirely clean slate, the people part of the equation would receive much more weighting than it has historically. Depending on the business, it likely outweighs the capital side. Through an understanding of business models, one sees that the significant influence of the employee within the model demands a change in historical compensation practice, especially in uncertain times. Competition for employees will accelerate the changes coming. Those businesses that have implemented such changes perform better, on average, than their peers. If one could run a business without being beholden to outside capital interests, why not? Success or failure rests primarily on the employees in any case. This reality leads to the ultimate solution, employee ownership of the business. With such ownership, the rewards accrue to those who have created them.

Equitable business models are the future. More businesses will become equitable through broader application of significant pay for performance tools, and more people will desire employment in equitable businesses. In order for equitable business models to function, transparency (open book management) within the business must occur. Technology greatly facilitates this transparency. Employees should be concerned with and seek to understand the business model that is followed by an employer.

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