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Professional Services Firms and Pay to Performance

Q: **Apart from financial measures such as billable hours, how can professional services organizations measure performance at an individual level and link this back to overall company performance in order to appropriately award out incentive payments?**

--- Pay for Performance-Minded, managing director, consulting/legal, Melbourne, Australia.

A: In any incentive plan design, the key issue is always the design of the performance measures. Regarding the structure of typical compensation schemes, your company should review client-performance metrics to understand and effectively address new projects, new clients, and client-relationship management.

Developing effective performance measures necessarily entails understanding client-relationship metrics that are truly important to the business from a strategic standpoint. Design the measures so as to both motivate individual participants and achieve desired company results.

In a professional services organization, project deliverables, client satisfaction and quality of work are generally considered to be critical measures of performance, as the quality of client relationships can make or break the firm. Since client-relationship management is typically team-oriented, incentive plans will also incorporate objectives based on team achievements.

Typical performance measures might include:

- Productivity on client projects (performance to project budget, deliverables, resource allocation).
- New business development (revenue generation).
- Client satisfaction (quality and timeliness).
- Contribution to profit.
- Consider paying based on revenue achieved versus hours, since hours may be charged at different amounts by project or client.

A second critical component of any program is the determination of payout levels. Most organizations with formal plans set what are called “target” levels of payout. These targets can be expressed as a percentage of base pay, as a fixed or varying dollar amount, or as a percentage of an incentive pool of dollars.

Target payouts are usually determined from an analysis of total cash compensation in the marketplace, as management is looking to keep total pay competitive. This requires a defined comparator market, as well as a defined compensation position. (Example: “Our company will set pay levels at the 50th percentile of the competitive market for base salary, and at the 75th for total cash compensation.”) Payout potential usually varies by level in the organization.

In addition, upside potential and downside risk also need to be addressed. This process includes establishing maximum payouts and setting payout thresholds where payouts are zero below a certain level of company performance.

Some organizations use uncapped plan payouts, although we certainly do not believe this is appropriate in all programs. Are rewards highly leveraged—that is, does the payout increase substantially when a person's performance exceeds the set objective? Or do payouts increase more moderately?

Uncapped awards are usually reserved for sales incentive plans.

Finally, consideration should be given to the issue of leverage.

Here are typical considerations for developing incentive targets as well as payout leverage mechanisms:

- Consider anticipated/forecasted business and historical prior year actual results.
- Determine the percentage of revenue attributed to each business line.
- Use revenue goals by business line, set revenue goals per person.
- Set goals quarterly or semiannually; acknowledge management's right to adjust as the company reforecasts the upcoming three to six months.
- Consider whether to start incentive pay for achieving a threshold level less than goal and up to targeted goal and above.

As you can see, incentive programs require a substantial amount of analysis and design work. Done properly, this type of compensation can be designed to directly support the overall business goals of the firm, and can provide for appropriate and effective employee motivation.

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