A balanced compensation and ownership plan that incentivizes performance can also improve recruitment and retention efforts, positioning the company to achieve its business goals.

**How Did We Get Here?**

Key economic outlooks from such organizations as CFMA, ABC, AGC, AIA, and McGraw Hill all seem to predict relatively strong economic growth.\(^1\) As demand for construction projects returns to pre-recession levels, business owners and CFOs should be pleased. However, without enough employees to complete the work, responding to this demand is challenging.

This problem is not limited to the U.S.; the Construction Industry Training Board (CITB), a United Kingdom-based organization, recently surveyed approximately 300 construction employers and found that 42% struggle to recruit talent with the desired skill sets. The impact of this problem is significant: 18% of construction employers surveyed by CITB indicated this issue had hampered their growth in the past few years, and 5% of respondents indicated that it was jeopardizing their sustainability.

What has caused the inability of construction companies to close the hiring and retention gap? It can be attributed to demographics, downsizing, and competitive forces from within and outside of the industry.

**Baby Boomers Retiring**

One of the greatest hurdles for construction companies trying to ramp up
hiring and improve retention is based on simple demographics. Large numbers of skilled professionals in the baby boomer generation are now retiring and will continue to do so throughout the coming decade. Baby boomers have played a major role in the development of the construction industry, and as they leave the full-time workforce, they take a high level of expertise and knowledge with them.

Recent Cost-Cutting Strategies
The second factor in the hiring and retention gap is the ongoing impact of the recent economic downturn. During the recession, as projects slowed and stopped, many businesses had to cut costs by downsizing the workforce. Skilled people left the industry because there was simply not enough work for them.

Industry Competition
The third factor in the labor shortage is also related to the recession, but on the upswing side of the economic cycle. As construction demand increases, businesses need more people to do the work, which creates more positions to fill. The construction industry is trying to fill pre-recession roles at the same time that it is trying to fulfill growing labor demands from a smaller talent pool.

External Competition
Last, construction companies are facing external industry competition for some of the same skilled workers. As manufacturing, oil and gas, and other industries grow, they too need more professionals with skill sets similar to what is needed to succeed in construction – math, engineering, and project management.

Adding to the hiring challenge are perceptions about the construction industry that may affect both new and experienced professionals who are exploring different career opportunities in the recovering economy. Whereas the oil and gas and high-tech industries are perceived as booming and high-paying, construction is often viewed as an industry in which high-growth opportunities may not be as easy to come by and unpredictable downturns are more likely. This perception has created recruiting challenges within trade positions, where many of today’s talented construction leaders started and worked their way up.

Strategies to Drive Performance & Satisfaction
In addition to ongoing industry efforts to address the labor shortage – including education, technology, and promotion – companies must assess their own operations to develop the kind of positive and productive work environments that both attract and retain high-level performers. An effective strategic reward system is fundamental to business performance.

While many executives realize that they need solid performance management and reward strategies and systems, too often they make the common mistake of rewarding one behavior when they actually seek a different outcome. According to Reward Systems: Does Yours Measure Up?, a successful performance system features three primary elements:

1) Define desired performance in tangible goals and actionable items.
2) Measure the right things and use the right measurements.
3) Reward the right measures with the right rewards.

Define
Rather than maintaining vague or intangible mission statements, management must take a hard look at the activities that drive desired results and, ultimately, economic value. “Unmatched customer service” is a great slogan for a motivational poster, but, “responding to customer complaints within 24 hours 100% of the time,” is a specific, measurable employee expectation.

Goals should be based on the demands of stakeholders – customers, suppliers, owners, and others. The CEO and owner must be kept informed of performance on all goals. To keep employees focused, driven, and not overwhelmed, many experts recommend a limit of 3-5 employee goals. While some organizations have 10-20 critical, actionable goals, these goals should be assigned only to the appropriate people with the responsibility to accomplish them. The CFO might be assigned goals that relate directly to profitability, whereas the controller’s goals may be more operational.

Measure
Ensuring success, both in terms of business growth and employee satisfaction, requires developing metrics that track actions and progress toward goals. The quality of metrics rests heavily on how well strategic performance is defined. As the saying goes, “you can expect what you inspect.” In most situations, the ability to measure outcomes drives results.

Implementing a new performance and reward system that includes tracking performance with hard data can be
intimidating at first. One recommendation to help employees move beyond the initial psychological barrier of data-driven performance is to use data for developmental purposes in the beginning of the implementation phase of a new performance system. Metrics are only used in performance evaluations once employees understand the goals and measures that support them.

Beyond the well-known key performance indicators (KPIs) like profit and revenue, construction executives should also measure economic indicators based on employee performance. (See “Key Performance Indicators Are Not Just About Profit” by Shane Brown and Andrew Steger in the March/April 2013 issue.)

**Reward**

Once goals are defined and measurements are implemented, it is time to consider rewards. Performance rewards can be both financial and nonfinancial, and must reinforce the organization’s performance metrics and measure employee contributions. Companies often have the right long-term goals but mistakenly reward short-term objectives.

The more significant the reward, the more employees will consider how it is measured. In addition to the size/value of a reward, three other elements make rewards impactful:

- Rewards that are highly visible are more powerful than hidden rewards.
- Timing rewards in association with outcomes drives positive behavior. For example, a bonus that comes a month after a goal is achieved will have greater impact on employees than one that occurs months later.
- Finally, staying power impacts reward power.

Bonuses, incentive pay, variable compensation, and compensation-at-risk are good methods for incentivizing positive behavior while preventing it from regressing.

Retooling a company’s performance strategy may seem daunting, but there is good news. It’s likely that competitors’ organization performance plans are not fully developed or implemented. This presents an important opportunity for companies to make a solid performance and reward system a distinctive competency and a competitive advantage. The remainder of this article will explore current tools and how your company can get strategic with its compensation.

**Current Compensation Tools**

Many companies use limited compensation tools that are not linked with their strategic plans. Base salaries, bonuses, and stock ownership are well-known compensation strategies. Base salaries will always be a pillar of hiring and retention strategies, but organizations rarely attract or keep skilled professionals on that alone.

Usually, job offers aren’t shared with current employers until professionals submit their resignations. The owner’s typical defense is to try to convince employees to focus on longevity and stay with the company. However, these professionals don’t have an incentive to stay if they don’t see a direct link to their future with the company from a compensation perspective.

Bonuses and stock ownership have their benefits, but here too, these methods of compensation don’t always have an obvious connection to hiring and retention strategies. Bonuses almost always rely on short-term corporate success. Yet, many key professionals’ contributions do not yield immediate results that the company deems worthy of bonuses (regardless of how well these employees outperform others). Talented individuals may be told that they are operating at a high level and that better times are on the way, but are not financially rewarded for their contributions, which increases the risk of key competitors courting them.

Often, stock ownership plans are offered to employees in an effort to get them to “take ownership” of the company. Enough ownership value and risk will accomplish this goal, but when the objective is to push the idea of “ownership” down through the organizational hierarchy, there may not be enough true financial ownership to go around.

Employee stock ownership plans (ESOPs) are the extreme end of the spectrum of employee ownership, and enable almost all employees to be owners. Executives of ESOP-based companies spend a great amount of effort creating a culture of ownership, and risk and reward are spread so widely that their full effects are harder to bring to the forefront. Possibly the biggest challenge with ESOPs is that real financial rewards for employees could be decades away. High-performing employees sometimes leave organizations in order to sell their stock, as they have no other option to realize value.

Another problem with relying on base compensation, incentive compensation, and ESOPs is that the exact same pool of assets is being leveraged for both basic performance and for hiring and retention. So how can compensation be strategically leveraged for hiring and retention?
Getting Strategic About Compensation

Most companies develop strategic plans that have extended horizons of three, five, or even 10 years. So why are compensation strategies and employee performance incentives typically based on annual salaries and bonuses, or, have long reward horizons as in the case of ESOPs? Why don’t companies link their strategic success and plans to incentive-based compensation structures?

When executives are faced with making significant investments in markets, geographies, acquisitions, or new competitive strategies, they can use mid-term incentive programs to ensure success in investments of capital, resources, and reputation.

When employees are vested in the strategic plan and know that a significant mid-term reward accompanies success, they are less likely to entertain offers of short-term compensation increases when they are close to achieving a larger reward from their current employer.

The key is to leverage one or more compensation strategies that will motivate employees while aligning their behaviors and job performance with company goals. Whether business goals are short-term (e.g., improving financial performance or attracting employees) or long-term (e.g., increasing business value or transferring ownership), the goals of the owners should drive the compensation strategy. The strategy may include a combination of plans for different levels of employees and positions. For example, positions susceptible to higher turnover may be best suited for bonus incentive plans. Other positions may be better suited for long-term rewards. (See Exhibit 1 for the spectrum of key benefits and the types of employees for whom they are best suited.)

The mid-term strategies that follow specify that when specific goals are met, the organization’s growth in value is far greater than the rewards distributed. These mid-term strategies allow the organization to leverage future success in the form of incentives to be paid later.

Bonus Incentive Plans

Bonus incentive plans are cash rewards for the achievement of individual or company performance metrics. This reward system is ideal for maintenance managers who are key to sustaining day-to-day operations and have technical knowledge. The measures for the plan are often profit-based rather than focused on company value.

Bonus incentives typically encourage performance over one fiscal year and can be very flexible and inexpensive to administer. They can be funded either as a percentage of earnings generated from goal achievement, or a fixed dollar amount funded into a bonus pool at the owner’s discretion. Employees are taxed on bonus income as ordinary income and the employer receives a corresponding tax deduction following distribution. Under federal tax law, a bonus must be paid within two-and-a-half months after an employee has earned it, or it may be subject to taxes under IRC §409A.

Deferred Compensation Plans

A deferred compensation plan is a nonqualified benefit plan under which an employee defers current income to a future date and the employer makes an unsecured promise to pay the employee future compensation. More long-term than bonus incentive plans, this option is flexible and designed to allow top earners to take advantage of the voluntary pre-tax deferral of salary, bonuses, incentive pay, and 401(k) contributions over the plan’s maximum dollar limit. The arrangement must be made before compensation is earned, and the compensation is not available until the previously determined date or event.

Subject to IRC §409A, the deferred income is not taxable for employees until it is distributed and, similarly, the employer does not receive a compensation-based tax deduction until that time. Permanent life insurance is a popular method of deferred compensation plan funding, usually providing retirement benefits to the employee and death benefits to the employee’s beneficiaries.
Stock Appreciation Rights Plans
Stock appreciation rights (SARs) are contractual rights usually granted by an owner to management. Recipients share only in an increase in the company’s value from the date of grant. This plan type is intended to incentivize behaviors to drive growth and value creation from the date of grant forward. The ideal candidate for this type of plan has control and authority to drive results, including decision-making managers who think strategically, solve problems, and are instrumental in business success. SARs incentivize “ownership thinking” without diluting existing ownership.

These plans do not involve the issuance, purchase, or redemption of stock, nor do they dilute control of the company or convey voting rights to management. No tax is payable by management upon receipt of grant of a SAR; however, IRC §409A specifies as to when cash can be received. Careful planning is required, as owners must take great care in valuing the company and the associated tax and cash flow planning.

Phantom Stock Plans
A phantom stock plan is a contractual right granted by an owner to management that permits managers to receive a share of all the value in the company from its inception. Similar to SARs in many ways, phantom stock plans reward both past and future appreciation in the business and are ideal for long-time employees who made important contributions when company stock had little or no value. Phantom stock plans also incentivize ownership thinking and do not involve stock, company control, or voting rights. IRC §409A applies to phantom stock plans, although tax is only payable when cash is received (if addressed properly).

Stock Option Plans
Compensation strategies may also include three types of stock option plans: incentive, nonqualified, and restricted. These options are all contractual rights granted by management to allow an individual to purchase stock from the owners at a fixed price during a specific time. These plans are ideal for leaders who are trusted to carry on the ownership’s legacy. They tend to be more long term than other plans, as they provide for true ownership.

Incentive Stock Option Plans
Incentive stock option (ISO) plans involve two important considerations: the dilutive control of the company and voting rights to management. ISOs are granted to select employees as an incentive to attract and retain top talent. From the employer’s perspective, they generally have fewer tax advantages. In these situations, employers provide management with stock incentives in lieu of salary raises and are not generally entitled to a tax deduction. Subject to IRC §422, employees receive stock yet may be able to defer taxes until stock is sold (however, there are potential Alternative Minimum Tax implications), at which time the employee is generally subject to capital gains treatment on appreciation.

Nonqualified Stock Option Plans
Nonqualified stock option (NSO) plans are similar to ISOs. An important difference, however, is that they can be granted to employees as well as independent contractors and board members. NSOs typically have more employer tax advantages than ISOs, and employees are taxed at the date on which the stock is exercised (before stock is sold and proceeds received) and are subject to ordinary income tax. These plans are also subject to IRC §409A.

Restricted Stock Option Plans
Restricted stock option (RSO) plans combine the benefits of equity-oriented plans with performance provisions. In this strategy, the employer places performance restrictions on stock options and, as a result, has some control over timing of tax deductions. Generally, RSOs have more tax advantages than ISOs and NSOs, as the employer is entitled to a tax deduction equal to the ordinary income recognized by the employee. Employees participating in these plans may elect to defer ordinary income treatment until after achieving performance provisions and may elect to receive capital gain treatment.

Net Profits Interest Plans
Net profits interest plans are designed only for LLCs and partnerships, and may or may not grant management voting rights. They offer an even more long-term position, as they grant participation in annual income and future appreciation to employees. This strategy is useful when key employees possess the knowledge, ability, and commitment to carry on the ownership legacy, which improves the likelihood of a successful transition. Granted interest represents a transition to a known party familiar with value drivers of the business. Annual income is taxed according to the character of the entity’s income (ordinary income or capital gains).

Employees benefit from net profits interest plans via participation in future appreciation according to the employee’s percentage and through annual income resulting from the employee’s percentage of net profits. One unique attribute of this option is that the employee pays no taxes at grant date, as net profits interests have no value at that time.
Minority Ownership Plans

Minority ownership plans are another viable option when key employees possess the knowledge and skills necessary to carry on the ownership legacy. Granted interest in these plans represents a transition to a known party familiar with value drivers of the business. It also represents the beginning of ownership resting in new hands.

Employees who participate in minority ownership plans gain ownership of a fully vested interest in the business. With this option, key employees receive an already vested and exercised interest (as opposed to stock options) either through purchase or as compensation.

If the business interest is purchased at less than fair market value, then the employee is subject to ordinary income tax on the gains (full market value of the interest, less the amount paid). In this situation, the corresponding tax deduction is available to an employer equal to the ordinary income amount. If interest is distributed as compensation, then the employee is also subject to ordinary income tax on the gain (the value of the interest on the grant date) and, similarly, the employer receives a corresponding tax deduction equal to the ordinary income amount.

Regardless of purchase or compensation, an employee is generally allowed long-term capital gain treatment when he or she sells the interest if it is held for more than 12 months.

Conclusion

Winners and losers in the construction industry will largely be determined by their ability to attract, retain, and develop future leaders. Employers with the best talent and, therefore, the best ideas and skills to get the job done, will achieve their strategic goals.

As construction demand returns and companies enhance their services and products, however, it may become more difficult for employers to differentiate themselves in order to attract top talent.

Contractors should evaluate these compensation options to gain the advantage in attracting and retaining key employees in a highly competitive market. In doing so, they will be better positioned to grow organizational value and achieve strategic goals. Ideally, compensation strategies should be linked to corresponding business goals in the company’s strategic plan and applied at the appropriate time in the growth of the business.

Before implementing any plans, owners should consult the advice of attorneys, CPAs, and other trusted business advisors to make certain that compensation strategies are legally and financially viable as well as a good fit for the owners, business, and employees. Compensation plans will need to be proactively communicated to financial statement users, such as sureties, bankers, and other key users, prior to adoption.

Endnotes


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