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It's not just what you pay, but why

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Setting a compensation structure should begin with a focus on the key aspects of the purpose of compensation.

It is more complicated than ever to determine the right compensation/incentive structure for key players at small-to mid-size businesses.

Setting a compensation structure should begin with a focus on the key aspects of the purpose of compensation, recognizing these sometimes conflict, and that the balance between these aspects will shift during a company's life cycle.

Key aspects include:

- Economic benefits should be outcome-driven and allow players to make their money at roughly the same time.

- Performance incentive, which is task-driven and considers the type of behaviour a company wants to encourage and what performance metrics are tied to the value of the company – high-performing companies monitor and tweak this aspect continuously.

- Governance and control – who is driving the bus? Who should be?

- Cash, which is liquidity-driven, both for employees and the company, but in the early stages everyone should stay lean and hungry.

The key is to get the big stuff right, which boils down to alignment – of incentives, actions and outcomes – and the recognition of human nature. Any compensation structure that fights this is most likely doomed to fail. Having said that, setting compensation involves experimentation and tweaking for unforeseen events, so expect errors, but minimize their cost.

Kevin O'Neil, partner at Sapient Capital Partners, says companies tend to set compensation plans and never re-revisit them until they have lost a key employee or they have aggravated their employee base and eroded internal goodwill. Compensation plans should be revisited annually, particularly in rapid growth businesses that rely heavily on attracting and retaining the best talent, he says.

Here are some key areas to consider:

Equity stake All core team members should have equity, whether bought or earned, with the owner maintaining control of the corporate affairs of the company. Team member shares should be restricted, i.e. no voting or put rights; a reasonable drag-along right, whereby the owner can compel their team to sell their shares if they decide it is time to exit; no right to veto raising third-party capital; shares should vest in a way that facilitates the ultimate outcome or exit you are trying to achieve; and they shouldn't be shorter than two years.

As a general observation, owners should be stingy with equity. In a recent example of how aggressive companies can be, online game company Zynga reportedly took shares away from employees whom they felt held an unwarranted equity position. However, O'Neil warns there is a "healthy level of stinginess" regarding distributing equity. Too many entrepreneurs are too stingy and grossly restrict growth because they cannot attract or retain top talent, he says.

Bonus pools These are a great way to empower and incent the rest of the employees and can be fairly generic – tied to reported sales, cash flow or profit – or set up for specific projects. Bonus pools should be simple, well-defined and transparent in how they are calculated. Each employee's share of the pool is a another matter, and should be managed discretely to minimize conflicts and dissention.

The proportion of total compensation made up by the bonus pool will vary widely depending on the industry and stage of the company.

Option pools Investors tend to see option pools as complications in raising additional capital. They also have less incentive and loyalty power than cash and shares. The public markets are wrestling with this issue, but private companies, which are cautious about options, are ahead of the curve on this.

Managing superstars Most high-performance companies have their Alex Rodriguez — a star infielder with the New York Yankees – the employee whose overcompensation is matched only by their importance to the company, and for whom all the rules are ignored. These individuals tend to be even more prevalent when venture capital or private equity investors are in the picture.

But it is important to ensure only true superstars, and not simply good performers, are being treated like superstars. Companies can identify superstars once they have gained a clear understanding of how they make their money, and which roles truly drive value. Don't be fooled by a resumé, or the loudest person in the room.

Company board When it comes to compensation plans, a board's practical insight can be a critical trip-wire for problems and imbalances. It should help ensure you remain competitive by keeping the best employees and by enforcing the right balance of the key aspects of compensation plans.

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