

# Applying Principle Based Management: Our Approach to Compensation



PRINCIPLE BASED  
MANAGEMENT GROUP  
& TOTAL REWARDS TEAM

At Koch Companies, we strive to recognize and reward individuals in a way that motivates them to maximize their contribution to the long-term success of Koch consistent with Our Values.

This requires all supervisors and HR personnel to understand and strive to apply our approach to financial incentives and other things that motivate employees.

This set of one -page guides provides information and guidance to **spur critical thinking and facilitate thoughtful discussions** with your supervisor and/or HR business partner. These guides focus on principles and do not attempt to answer every specific question or tell you exactly what to do.

While these tools were created for supervisors and HR personnel, they can be useful for all employees to better understand our approach.

## TABLE OF CONTENTS

1. Some Key Principles
2. Forms of Financial Incentives and Other Motivations
3. Conducting a Compensation Review
4. Using Market Data Effectively

# Applying Our Approach to Compensation: Some Key Principles

## AN IMPORTANT DISTINCTION:

The *Principle Based Management approach to pay* is different from *market-based pay*. Market-based pay means following what other companies in the market are doing—such as strict pay ranges for positions.

Since we are competing for talent, awareness of others’ pay practices can be helpful, but any practice we adopt must be consistent with our philosophy and objectives.

## OUR PHILOSOPHY AND OBJECTIVES:

We recognize and reward individuals in a way that motivates them to maximize their contribution to the long-term success of Koch consistent with Our Values.

One of the best ways to do this is to reward employees for their contribution to the company's results and value created—similar to how an entrepreneur is rewarded in the marketplace. In this pursuit, we will always comply with applicable laws, agreements and contracts.

We believe this approach helps us attract and retain contribution-motivated individuals and motivates them to be principled entrepreneurs.

PRINCIPLE	DESCRIPTION & TIPS	WATCH OUTS
<b>Respecting Each Individual (Individualism)</b>	Each person brings different perspectives, aptitudes, skills, knowledge, experiences and backgrounds to the organization that determine how and where they can contribute to value creation.  We pay people, not positions.	<ul style="list-style-type: none"> <li>Assuming people with the same job title, tenure, credentials, etc. contribute the same or have the same market alternatives.</li> </ul>
<b>Rewarding for Mutual Benefit</b>	For any recognition or reward (financial or otherwise) to achieve our objectives, it must be mutually beneficial; that is, good for both the employee and the company.  Employees must strive to build win-win relationships with their co-workers, customers and all those with whom they work.	<ul style="list-style-type: none"> <li>Taking on the role of either employee advocate or company advocate instead of viewing each pay decision through the lens of mutual benefit.</li> </ul>
<b>Subjective Value</b>	Because individuals are different, they value things differently. This should be considered when determining both financial and non-financial incentives.  It requires good judgment to apply this in a mutually-beneficial way.	<ul style="list-style-type: none"> <li>Assuming every employee values the same things you do and/or to the same degree as you.</li> <li>Undervaluing non-financial incentives as a tool for motivating and retaining contribution-motivated individuals.</li> </ul>
<b>Motivate / Motivation</b>	<i>Motivate</i> stems from a Latin word meaning “to move.” Financial and other types of incentives should motivate employees to fully develop and apply their capabilities to maximize long-term value for the company in a principled way.  Recognition and rewards must be earned to be an effective incentive.	<ul style="list-style-type: none"> <li>Assuming employees will be “de-motivated” if they don’t like a pay decision.</li> <li>Assuming any pay increase will be viewed favorably by an employee.</li> </ul>
<b>Total Compensation for Total Contribution</b>	Aligning an employee's base pay, variable pay, and other incentives (total compensation) with their contribution to team/business results, long-term value to Koch and our Principle Based Management culture (total contribution).  Total compensation for two employees with the same job title could vary greatly based on each person’s contribution.	<ul style="list-style-type: none"> <li>Simply applying percentages to determine a bonus or base pay change.</li> <li>Fixating on base <u>or</u> variable pay rather than total compensation.</li> </ul>
<b>Marginal Contribution</b>	A form of marginal analysis where we assess an employee’s contribution compared to a “typical contributor” (someone performing at the median for a peer group in the market).  A person’s marginal contribution could be <u>above or below</u> that of a typical contributor.	<ul style="list-style-type: none"> <li>Identifying any positive behavior or result from an employee as a marginal contribution.</li> <li>Assuming marginal contributions can only occur by working on projects.</li> </ul>

# Applying Our Approach to Compensation: Forms of Financial Incentives and Other Motivations

## FINANCIAL INCENTIVES

At Koch Companies we use a mix of base pay, variable pay, and non-financial incentives to achieve total compensation for total contribution.

<p><b>BASE PAY</b></p> <p>We treat base pay as an advance payment for the value an employee is expected to create for the company.</p> <p><b>Watch outs:</b></p> <ul style="list-style-type: none"> <li>• Treating base pay as entitlement for putting in time, acquiring credentials or holding a certain position.</li> <li>• Making decisions based on a budget mentality.</li> <li>• Making adjustments in increments that indicate a level of precision that is unrealistic.</li> </ul>	<p><b>VARIABLE PAY</b></p> <p>A bonus or other deferred compensation used when an employee creates <i>more value than reflected in base pay</i>.</p> <p><b>Watch outs:</b></p> <ul style="list-style-type: none"> <li>• Treating variable pay as an entitlement or guarantee based on title, position, a performance rating (such as “exceeding expectations”) or company performance.</li> <li>• Anchoring to previous variable pay amounts to make a current recommendation. (Default/reset is zero)</li> <li>• Assuming total compensation for total contribution always requires a variable component.</li> </ul>
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## COMMON FORMS OF VARIABLE PAY

Every employee can earn variable pay. Below are the most common forms of variable pay used at Koch companies.

<b>Incentive Compensation (I-Comp)</b>	A form of variable pay (approved at the KII Board level) typically reserved for employees whose contributions have a long-term, strategic impact on the direction and profitability of the company.
<b>Spot Bonus</b>	Bonus that rewards a specific, exceptional contribution to value creation. It is to be awarded as close to the contribution as possible, not at a set time interval.
<b>Others</b>	Because Koch operates in many industries and in many regions, there are various other forms of variable pay used across the enterprise. <u>Some</u> examples are Performance Pay for manufacturing, sales incentives, annual variable pay, recognition rewards, project bonuses and longer-term variable pay (PUPs).

Work with your supervisor and local HR to understand the methods used in your area and to determine, for specific situations, if variable pay makes sense.

## OTHER MOTIVATIONS

While employee pay is important, other things are motivating and meaningful to employees as well. And, since each employee is a unique individual, there is no one-size-fits-all approach. Here are some things that might be important to your employees. Have conversations. Find out!

Feeling appreciated and included	Growth and development opportunities	High-performing team; teamwork	Flexibility; work/life balance	Expanded decision rights
Meaningful work; making a difference	Work environment; culture	Challenging assignments	Training and conferences	Others...

# Applying Our Approach to Compensation: Conducting a Compensation Review

## SUPERVISOR EXPECTATIONS

Supervisors at Koch Companies are responsible for making pay recommendations for their employees. At least once a year, supervisors should assess each employee’s performance and contribution, review each employee’s compensation, and communicate the pay decision (even if there is no change in pay).

To meet these expectations, supervisors should:

- maintain an on-going point of view on each employee’s performance and contribution
- maintain a reality-based view of market alternatives
- understand and apply the key mental models of our compensation philosophy
- work with their leaders and HR partners to improve thinking and decisions
- maintain compliance with applicable laws, agreements and contracts

In a high-inflation environment or when there is a shortage of certain skillsets, it is important for supervisors to review the pay of their employees more frequently than once a year. You should, however, apply the same principle-based approach to pay decisions regardless of the economic conditions. [Here’s a video to learn more about inflation in general.](#)

## GENERAL COMPENSATION REVIEW STEPS

Applying our compensation philosophy requires critical thinking and judgment. Focus on being directionally correct.

Assess employee’s total contribution	Determine appropriate compensation signal and make recommendation	Check your recommendation against market alternatives, seek guidance and approval	Communicate compensation decision to employee
<p>How did the employee perform per their RRE?</p> <p>How did the employee contribute to team/business results? To our culture? To long-term value for Koch?</p> <p>Were there any carryover contributions from past projects/initiatives?</p> <p>How does this employee’s performance and contribution compare to a typical contributor?</p>	<p>What is an appropriate mix of base pay, variable pay, and other incentives (including non-financial incentives) so total compensation matches total contribution?</p> <p>Take a longer-term view. What is your incentives strategy for this individual? What makes sense to do now?</p> <p>What is your initial recommendation?</p> <p>Is your recommendation consistent with the message the employee needs to hear?</p>	<p>Once you have an idea of what you might do, consider the value of the employee’s market alternatives.</p> <p>Discuss your recommendation with your supervisor and HR; engage in discussion, be open to challenge that will improve the final decision—which could be higher or lower than your original recommendation.</p> <p>Ensure the basis for the compensation decision is appropriately documented.</p>	<p>If applicable, ensure formal approval is finalized in the HR system.</p> <p>Communicate pay decision with the employee (even if no pay change).</p> <p>If a pay change was made, communicate the amount, not a percentage change.</p> <p>Clearly communicate how employee’s total contribution connects to their total compensation.</p> <p>Own the message.</p>

# Applying Our Approach to Compensation: Using Market Data Effectively

We expect supervisors to maintain a current, reality-based view of the market for talent. **We do this to understand if we are being competitive in the marketplace and understand the value (range) of an employee’s market alternatives.**

Market survey data (among other things) can be used in this on-going process. Below is guidance on how to use market survey data.

**After** assessing the employee’s contribution and making an initial recommendation...

## Use market survey data as a check.

### First, be a thoughtful and informed consumer of market data.

- Who participates in the survey? Use reputable surveys.
- How do responsibilities in the market survey (or internal data) match up with your employee’s responsibilities?
- There is no exact market rate for an individual.
  - Each employee has their own market alternatives based on their experiences, skills, flexibility in location, etc.
  - Each employee’s RREs are individualized which makes it difficult to compare like employees across the enterprise or to match to survey jobs.
- Don’t try to find or construct a perfect match—it doesn’t exist. Instead, use what is directionally helpful!
- Look at total compensation, not just base pay.

### Next, use the market survey data as a check.

- Does the amount you are proposing stand out compared to the survey data? If so, this does not mean your recommendation is wrong. Instead, it should prompt thoughtful discussion with your supervisor and/or HR.
- When looking at market survey data, look at the entire range. Do not fixate on the 50th percentile (or 25th-75th percentile). Paying an individual below the 50th percentile could be appropriate and competitive given their contribution.

## Critical thinking and judgment are required.

### It’s data, not knowledge.

Market data (whether external or internal) does NOT tell you:

- performance or contribution of the participants
- actual responsibilities and expectations
- business performance

It may not accurately reflect:

- local market conditions
- current supply/demand trends for certain skillsets (when the market value for a skillset is changing rapidly, market survey data can be off significantly)

### Look for general guidance, not precision.

- Engage with HR to understand the market data you are using—don’t make assumptions, especially if you are new to using a specific survey or source.
- What have you learned about the market from people leaving or joining your team? This is another source of market information.
- Market survey data should not be used to establish a floor and ceiling for an individual’s pay.
- Remember, market survey data is ONE consideration—not the primary consideration in making a pay decision.