Compensation’s Role in Human Resource Strategy

Compensation is one of many human resource (HR) tools that organizations use to manage their employees. For an organization to receive its money’s worth and motivate and retain skilled employees, it needs to ensure that its compensation system is not an island by itself. Not only is it important for an organization to link compensation to its overall goals and strategies, it is important that its compensation system aligns with its HR strategy.

Too many organizations plan and administer their pay systems by default; or worse, fall back on “the squeaky wheel gets the grease” practices. More than any other area in HR, ignoring pay and performance systems can be devastating. It is a very expensive and laborious process to hire new employees, buy back trust of current employees and renew the organization’s energy and motivation level. By ignoring this issue, it does not go away or get better with time. It will take extra money and valuable resources to fix the system.

Smart, successful organizations do regular planning and evaluating of their compensation and performance appraisal systems. Because compensation is visible and important to employees, it is critical to consistently communicate a clear message regarding how pay decisions are made. In short, a solid pay-for-performance strategy requires that employee pay matches the organization’s message.

Engaging Key Stakeholders to Support the Compensation Strategy

There are three levels of compensation strategy that exist within an HR department. The first level is a strategy that is only understood and supported by the HR department. The second is a strategy that is supported by the HR department and translated into practical solutions, policies and decisions
that guide compensation decisions. The third level, which should be an organization’s ultimate goal, is the most difficult to achieve. It is a compensation strategy that supports a pay-for-performance system that transforms and permeates all levels of the organization.

The sooner that these important stakeholders are involved in the pay-for-performance system, the more successful it will be. HR must do its homework and conduct primary and secondary research to obtain answers to the above questions. Primary research is conducted within an organization by obtaining feedback from employees, board members and other key parties (city councils, union leaders, board of directors). Secondary research is information about what other organizations have done. In fact, this book could be described as secondary research to set up a compensation and pay-for-performance plan. Following is a suggested list of primary and secondary research resources for each of the three key stakeholders: employees, executive management/owners, and government.

*Employee Research*

**Primary research.** The most efficient and effective way to gather information

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<th>Key Stakeholders</th>
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<td>What is my employment deal?</td>
<td>How can I find and retain the best employees for the least amount of money?</td>
<td>How can we best balance competing interests? Minimum Wage vs. Living Wage Union vs. Non-Union American vs. Immigrant Workforce</td>
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directly from employees is to ask them. The newer generations of workers want and demand to be asked. An employee opinion survey is a quick and easy method to obtain information. (See tips on conducting an employee survey on p. 33.)

**Secondary research.** There is abundant information available (in books, magazines and the Internet) about paying new-generation workers. Real-life stories, trends and new ideas can be collected from colleagues and is an important part of information gathering. For example, one colleague pointed out that some Generation Y employees are willing to quit a job and move home with their parents. Many parents of Generation Yers are extremely involved in their adult children’s lives—sharing even their first day of work like their first day of kindergarten.

**Executive Management/Owner Research**

**Primary research.** Like employees, the best way to gather feedback from executive management and owners is to ask them about compensation and pay for performance. In order for HR professionals to gather high-level support to write compensation strategies and policies, management needs to understand why the organization needs this information. They must understand compensation strategies, issues and policies, and have a basic grounding in terms. They should understand why the organization needs to have this information. The best approach is to provide them with some information about the basics of compensation, where the organization currently stands and the benefits of a pay-for-performance system.

By holding a compensation philosophy meeting and offering a brief “mini training session” about compensation and pay for performance, HR professionals can motivate executive staff to complete a questionnaire. (*For more information, see Tool 1.*) This form can be e-mailed to attendees before or after the introductory meeting to solicit executives’ opinions on compensation topics.

**Secondary research.** Many executives do not want to change their traditional way of paying employees without some detailed research about what similar companies are doing with pay for performance. This information should be researched before meeting with executive staff. By anticipating their questions
and having some answers ready, HR professionals can raise their credibility with executive management and owners.

**Government/Other Stakeholders**

**Primary research.** In today’s security-conscious workplace, it is necessary to gather information regarding the types of government reporting and monitoring the organization may be under. In some cases, this may be only for the executive staff because of Sarbanes-Oxley.

The government is playing a larger part in minimum wage issues, including the “living wage,” which promises to pay higher than the minimum wage to reflect on where the organization does business. Until recently, this was not an issue in the forefront. Over the last two years, two cases arose that dealt with this issue. In one case, a city wanted to build a new hospital. City management had promised the mayor that they would not pay a living wage less than $3 per hour over the minimum wage. In the second case, an internal executive team verbally stated that it would raise the pay rates of its lowest paid employee to at least $4 over the minimum wage. This promise came back to haunt the team. After a comprehensive market study, it looked like they were going to have to make good on the promise or delay some very important moves to the minimum of the salary range for key middle managers.

**Secondary research.** Each state must follow federal guidelines for wages and hours, which vary from one state to another. For example, the state of California has so many unique employee-oriented laws that it has been dubbed, “The Republic of California.” As part of a project of this magnitude, HR professionals should be aware of the labor laws for all states where its organization conducts business.

**The Payoff of a Pay-for-Performance Compensation Strategy**

The biggest mistake an organization makes in setting up a pay-for-performance compensation program is to rush into getting answers before carefully considering the issues. Next to an organization’s strategic planning efforts, dovetailing the compensation philosophy to support the organization’s goals is paramount to success. It is important to discuss basic strategic pay decisions with senior management to ensure the success of the pay-for-performance
compensation strategy and prevent serious consequences, such as employee turnover and lawsuits.

Organizations that know how to manage their talent have the best results. This phenomenon has been studied continually with the same results. In his frequently cited paper on human resource management practices, Mark Huselid lists the following metrics associated with organization success and financial advantages:
- A 7 percent decrease in turnover
- An increase of $3,800 in profits per employee
- Approximately $27,000 in additional sales per employee
- An increase of $18,000 in market value per employee

**Important Considerations in Designing a Compensation Strategy**

Does the compensation system match the organization’s overall objectives? In other words, how does the compensation strategy complement other HR initiatives? For example, if quality, experience and a sophisticated skill set are an organization’s strategic advantages, then it will not be successful hiring employees significantly below the market rate for that position. To answer this question, it is important to review the organization’s strategic plan (at least annually) and discuss whether the current HR and compensation systems are supporting these initiatives.

![Figure 2 Market Position Choices](image-url)
Where does the organization want to be in terms of market competitiveness? In this competitive job market, it is important to be aware of the organization’s competing firms. An organization can lead, meet or lag the market.

**Lag the Market**
An organization may choose to offer a compensation package that is valued less than packages offered for a similar job in the labor market. An employer with a “lag the market” philosophy is likely to be at the back of the line when it comes to hiring and retaining employees, especially those with special skills. These problems are the direct result of below-market pay. With the Internet providing pay information with a click of a mouse, employees are less willing to stay and support an organization when they know they are underpaid. Good employees may leave, while less-skilled employees may stay with the organization.

Turnover is very expensive. It is estimated to be at least six months’ pay for a non-exempt (hourly) employee and one years’ pay for an exempt (salaried) employee. No organization wants to be a training ground to groom employees for its competitors.

**Meet the Market**
This is the most common compensation strategy. This level of competitiveness occurs when an organization’s compensation strategy is equal to the labor market for the same position. This is the pay philosophy that makes the most sense for most organizations. By having a base pay strategy that meets the market, an employer can easily add or subtract variable pay and/or fringe benefits. By selecting this level, employers can balance cost pressures and the need to attract and retain employees.

**Lead the Market**
The “lead the market” pay strategy can be defined as a total compensation package that is above the labor market for a similar position. This strategy may occur because an organization believes that by paying more, it will receive more experienced employees for the same position (although it has not been proven that a higher salary guarantees higher-quality employees). Organizations may select this market in good financial times, but leave them in a tight spot in a downturn.
**Mixed Market Position**

This market position is becoming more common as employers are realizing that a one-size-fits-all strategy does not suit their workforce. The following are examples of a mixed market pay policy:

- An organization that is several miles outside a major city may be able to pay lower for their lower-level hourly employees to match a lower cost of living, but may have to pay at market or above market to attract employees to a smaller, more remote city.
- An organization has a mix of difficult-to-fill clinical positions and easier-to-fill administrative positions. To compete in a market with an extreme shortage, it may make business sense to pay the clinical positions at least at market or above market and pay the administrative positions closer to below market.

**What are the strengths and weaknesses of the organization’s current compensation system?** An important component of market competitiveness is to find answers to the following questions:

- Is the organization able to attract the appropriate skill sets and types of employees when needed?
- Where is the organization hiring its best employees?
- How long do most employees stay at the organization?
- Where do employees go when they leave the organization?
- What are the organization’s promotion policies?
- Are employees frequently asked to take on new tasks without being rewarded for their efforts?
- Do employees value the company’s benefit, incentive, work environment? What of these items should be changed or updated?
- What is the employee morale? This information can be gathered from managers, exit interviews, employee surveys and other communication tools. Employee survey feedback, in particular, provides valuable information for moving forward.
- What mix of base pay, incentive pay, work environment and benefit levels make the most sense for the organization when considering the competition, types of jobs, niche and labor market available?

**How is pay distributed?** How does the organization’s current compensation plan link pay with performance on base pay?

- Is there a pay matrix that rewards high-performing employees with a larger annual merit increase?
How well does the organization’s performance appraisal process work?
Are the organization’s promotional pay policies consistent?
Does the organization review where employees fall on the pay range according to experience, performance and longevity?

How is the organization’s pay system administered? What are the strengths and weaknesses of the current system?

How is your system structured and what do you want to change about the following:
- Number of grades
- Separate scales for different types of jobs such as non-exempt, exempt and executive
- Size of jump between grade mid-points
- Placing a newly created job in the pay range
- Determining how and when a job gets reviewed due to changes in responsibilities

What are some constraints? It is too easy for an employer to take a shortcut and not acknowledge that all organizations have to work within some important constraints when managing their pay-for-performance system. There are five major constraints: the organization’s ability to pay; legal constraints; union and non-union issues; the internal labor market and the external labor market.

1. **Ability to pay.** Fancy compensation programs are impressive, but the bottom line is that an organization must be able to afford its pay system. This is true in good and in bad financial times. It is critical that design decisions align with the organization’s financial ability to pay. By partnering with an organization’s chief financial offer, it will be easier to develop a plan that makes sense financially.

2. **Legal constraints.** In general, base pay plans are regulated by the Fair Labor Standards Act (FLSA), which regulates wages, hours and recordkeeping.

3. **Union/non-union issues.** For unionized organizations, pay issues are a mandatory bargaining issue that must be negotiated. Organizations must obtain buy in from union leadership early in the negotiation process to be successful in changing the way they pay their employees.

4. **Internal labor market.** This is where internal equity comes into play. Pay plans must motivate employees to want to stay with the organization and, hopefully, take on management roles or higher-level technical roles in the
future. To illustrate, an organization can structure a pay plan that will motivate high-level technical employees to move out of overtime eligible positions into first-line management positions that do not pay overtime.

5. **External labor market.** In today’s global market, organizations cannot operate their pay plan in a vacuum. Basic economics of supply and demand affect employee compensation. To illustrate, the amount of education required to become a pharmacist recently changed. To compound the problem, Medicare added a pharmacy plan for senior citizens. This resulted in a shortage in pharmacists and an increase in pay levels for the job.

Collecting information regarding the above compensation questions and issues will give HR professionals a good start in developing a compensation philosophy. Many organizations now advertise their compensation philosophies internally to their employees and externally to the general public, customers and potential applicant pool.

At this point, HR professionals should review opinions from their organization’s compensation stakeholders with the Compensation Philosophy Questionnaire. The final critical step is to merge all the opinions on the compensation philosophy questionnaire and other sources and then begin the first draft of the compensation and pay-for-performance strategy. This is too important of a document to sit on a shelf. HR professionals should enlist senior management to help champion it and complete it as a working document to set the stage for the design of the new compensation system.

**Goals for the Pay-for-Performance System**

A compensation system should influence employees to make personal decisions which are congruent with the organization’s needs. Generally, this goal can be broken down into three parts:

- Motivate people to join the organization.
- Motivate employees to perform at the top of their skill set.
- Motivate employees to stay.

**12 Steps for Designing a Pay-for-Performance System**

**Step 1:** Determine the organization’s pay philosophy. After senior management has determined the organization’s pay philosophy, the next step is to summarize it and review it with middle management.
Step 2: Determine the gaps. Where are the gaps between the compensation philosophy and what the organization is currently doing? Do not take on the world. Start with a long-term plan of approximately three years and prioritize what needs to be completed first. If this is a brand new compensation plan, or if it is a major remodel (nothing or very little has been done in three or more years), then start updating the base pay plan first. In this way, other plans that build on your base pay plan also will be done correctly.

Step 3: Update job descriptions. Since jobs change so rapidly, it is important to update your job descriptions before working on any other part of the compensation system.

Step 4: Decide what sources will be used for external market information. Use at least three salary survey sources for each job. Most surveys are published only once a year. This will save you money and make for a better survey to do some advance research in this area. By participating in a survey (usually requiring one short window of about six weeks per year), organizations can save almost 50 percent on the survey purchase price.

Step 5: Plan on how the market survey will be completed. Does the HR department have enough time and expertise to accomplish this task without outside help? Matching jobs to accurate salaries is more difficult than it appears. It takes many years of experience to have the confidence and the credibility

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<tr>
<th>Compensation Policy</th>
<th>Advantages</th>
<th>Disadvantages</th>
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<tbody>
<tr>
<td>Lag – Pay lags the market</td>
<td>1. Lower costs – more competitive</td>
<td>1. Hard to attract employees</td>
</tr>
<tr>
<td></td>
<td>2. Money can be used for benefits</td>
<td>2. Train for your competitors</td>
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<tr>
<td></td>
<td></td>
<td>3. Dissatisfied employees</td>
</tr>
<tr>
<td>Match – Pay matches the market</td>
<td>1. Pay and cost matches competition</td>
<td>1. May not be able to keep stars</td>
</tr>
<tr>
<td></td>
<td>2. During good times, (financially) can easily share bonuses and short-term incentives</td>
<td>2. Organizations may not be able to attract stars when labor market is tight</td>
</tr>
<tr>
<td>Lead – Pay leads the market</td>
<td>1. Able to attract stars</td>
<td>1. Must have profits or finances to be able to afford</td>
</tr>
<tr>
<td></td>
<td>2. Helps with long-term retention</td>
<td>2. During financial hard times, may not be able to change financial commitment quickly</td>
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<tr>
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<td>3. Helps with perception of employer of choice</td>
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with employee/management groups to do this task right. If this is a brand new salary plan, it may be a wise decision to work with an outside consultant who has experience in the process.

Step 6: Review market data and slot into salary grades. Each set of market data points must be reviewed to ensure there is a pattern with no statistical outliers. When there is a good average for each job, the next step is slotting the jobs into salary grades based on this salary survey market average.

Step 7: Review preliminary salary survey results with senior management. Senior management should be involved early in the salary matching process to obtain management buy-in at an early stage; identify and resolve problems before the project continues; and assess internal equity.

Step 8: Match employee titles to the market study titles. This step is usually harder than it looks. For many organizations, it is not clear what employees match up to which job descriptions and then which employees match up to new titles now used in the new salary grades. In many organizations, there is one title in the HRIS, another on the job description, another on the organization’s chart and another used on the employee’s business card. Even understanding who does what, who belongs in which department, and which supervisors oversee jobs can be confusing even in a smaller organization.

Step 9: Review financial impact of setting new salary ranges. In almost every case, there will be pay situations where the employee’s current salary is either above the new salary range (red circled) or below the new range (green circled). This is one of the few occasions in compensation where you need to be concerned with individual employee pay. First, take a look at all the employee pay that falls below the minimum. What is the financial impact of moving these employees up to the minimum? If cash flow and/or money are tight, get the chief financial officer involved in this process early because he or she will be crucial in deciding affordability and timing for all market adjustments.

Step 10: Review and update the performance appraisal process. Does the performance system work well with the new pay-for-performance system? If the performance appraisal process is more than two years old and it has been at least that long for any management training, set aside time to drive
this important piece of the project. A separate management committee should be assembled to assist with the performance appraisal’s design, process and delivery. This will take four to six months to complete. It may be a good idea to start this project right after the job descriptions are complete.

**Step 11: Design a pay-for-performance merit matrix.** After the performance appraisal form is complete, it is time to match the performance levels to be achieved against a merit schedule that rewards raises based on an employee’s performance. In order not to overspend, it’s important to do a dry run using last year’s employee performance scores with the new corresponding merit pay number. If the final numbers from this exercise are too high, then trim the merit pay matrix or raise the merit budget allowance.

Merit pay is the best pay system to use for a pay-for-performance base pay system for the following reasons:

- Merit pay’s basic philosophy fits well with the American work culture which is surrounded by the ideals of overachievement, creativity, independence and individualism.
- Merit pay systems manage an organization’s payroll wisely while rewarding high-performing employees.
- Merit pay budgets can fluctuate to reflect the organization’s financial status. Employees will not see merit pay as an entitlement.
- Merit pay is perceived as more fair because employees usually support pay systems that reward the stars.
- Merit pay will help with employee retention by retaining stellar employees and motivating lower-performing employees to step up their performance or move to another company.

**Step 12: Review, audit and communicate.** If done correctly, this important step will have a lasting positive effect on the organization. An integral part of each step in this entire process is a communication plan and a willingness to step back and audit the system. Before starting next year’s compensation, market study and communication process, gather specific information on what worked and what did not.

*Don’t Forget to Ask for Your Employees’ Opinions*

An employee attitude survey is one of the best ways to learn how employees view the organization’s HR programs. This tool collects data from an organi-
organization’s employees using written or electronic surveys. In particular, Generation X and Y employees want to have a “say” about their work environment. This survey data enables the senior management/HR team to improve HR programs and create a working environment that fosters better working relationships and increased productivity.

With the Internet providing an easier way to gather information and keep it confidential, many organizations conduct annual surveys. An employee survey is a double-edged sword. If done right, it provides valuable information and is perceived by your employees as a benefit because it gives them an opportunity to express their opinions. A survey also can have disastrous results if confidentiality is breached or employees feel their feedback does not impact the organization.

**How to Conduct a Successful Employee Survey**

The first step in conducting an employee survey is getting top management support. Management should take an active role in the survey’s design, delivery and action steps. Employees will wonder if the survey is worth their time and if their confidentiality will be guarded. To ensure a successful survey, top management will need to adhere to the following practices:

- **Deliver a summary of employee feedback within 45 days of the survey deadline.** This does not mean that all of their suggestions will be implemented. Provide a listing of items that have already been addressed, items that will be addressed over future months, and explain why some suggestions cannot be considered.

- **Maintain strict survey confidentiality.** If the survey is not completely confidential, it will affect the results of this survey and future surveys.

- **Design a survey format that appeals to a wide variety of employees.** It may need to be translated into another language. Do not assume that all employees have access to or are comfortable with a computer-based survey.

- **Increase employee participation by implementing a few clever marketing approaches,** including: setting aside a special room where employees can complete the survey while enjoying light refreshments during work hours; post a reminder list of the number of employees who have completed the survey; hold a drawing for a gift card for employees who participate in the survey; disseminate a letter from the company president explaining the importance of the survey and thanking employees in advance for their participation.
How to Design the Survey

The employee survey should pinpoint key issues and be designed to gather detailed feedback in a succinct manner. It should be a maximum of three to four pages, contain a variety of questions with numerical responses that can be calibrated, and have at least three or four open-ended questions to solicit feedback not covered in the numerical questions.

Many resources are available online (free or for a nominal fee) to help design and administer an employee survey. (For more information, see CD-ROM Tool 12.)

Do not make an employee survey a one-time event; rather, deliver a similar survey at the same time next year. Some responses may indicate serious HR issues that require further investigation and research by focus groups.

Carefully summarize the survey results. The best way to manage this step successfully is to ask the vendor in charge of the survey to summarize the data. If money is tight, this task also can be outsourced to a temporary clerical outside resource and/or a student intern. The key is for HR to create a summary by subject and interpret what it means for the organization.

Communicate survey results. The first step is to provide a rough draft of the summary to the senior management team and double check the action plan. The action plan needs to have the support of this senior group. Next, the results should be presented to the management team, and then the employee group.

REAL-LIFE EXAMPLE

The Case Study of the Dog Shelter Where Its Bark Was Worse than Its Bite

Most HR professionals have experienced a similar case to this—where a non-profit has a lot of tough rules on the surface. The management chickens out, however, when asked to enforce the rules or ask employees to perform at even the most basic level. Non-profit management explains this behavior by stating that it cannot make demands on its employees because it assumes that their pay is too low. This is not based on hard facts, only assumptions and the rumor mill. This caused good employees to leave the organization because they were disgusted with their low pay. Even more compelling is that they were disgusted with management’s tolerance of poor performance.
**What’s the Best Course of Action?**

This organization would benefit from an open discussion about its pay philosophy. It can set up policies to conduct a market study on a regular basis to squash rumors, implement a real performance appraisal system and then work on retaining good employees and moving out poor performing employees. This action requires courage; some managers may therefore leave.

**COMPENSATION BOOT CAMP**

**Concepts and Definitions**

- **Market lag policy.** This pay policy distinguishes companies from the competition by compensating employees lower than most competitors. This policy’s aim is to save money on payroll costs. In times of strong competition for employees, it may not save enough money to cover higher turnover and training costs.

- **Market lead policy.** This pay policy distinguishes companies from the competition by compensating employees higher than most competitors. This policy’s aim is to maximize an organization’s ability to attract and retain quality employees and to minimize employee dissatisfaction.

- **Market match policy.** This pay policy most closely follows the typical market pay rates.

- **Merit pay.** Merit pay is a pay increase given to an employee based on his or her performance level reflected in the performance appraisal. This pay increase is added to the base pay, usually as a percentage of base pay. If the increase places the employee’s salary outside the salary range, then it might be given in a lump sum.

**Sanity Suggestions**

- Communicate to executives, managers and employees that designing and installing a pay-for-performance compensation system are part of a long and difficult process. HR professionals should not box themselves into meeting arbitrary deadlines. They should make clear to senior managers, managers and employees what items are needed to meet project deadlines. For example, job descriptions must be compiled before performing a market study.

- **Set responsible expectations with a solid communication plan.** Participating in a major compensation study may be novel for many of managers and employees. By setting reasonable expectations, employees will not be disappointed that this project does not mean huge raises for everyone. Gen-
erally, only a handful of employees—those whose current pay falls below the minimum of the new salary range—will receive an increase in the form of a market pay adjustment.

- **Take the time to obtain accurate information.** A successful compensation system needs to take many external and internal factors into account. It is important to research compensation trends that relate to the organization’s job market for employees and what competing firms are doing. It also is important to incorporate trends that can put the organization on the cutting-edge rather than using a tool that is outdated and does not fit with today’s employee. For example, broadbanding, which has a 150 percent-wide salary range, was extremely popular 10 years ago. Today, almost all organizations stick to a more conservative 50 percent-wide range.

- **Conduct an employee survey at the onset of the project.** Even if the organization has an ineffective, outdated or almost non-existent compensation and benefits program, it is prudent to know what works and what does not work. This information can help HR professionals prioritize compensation-related matters. By accomplishing one task at a time and doing it well, they will have a process in place and the confidence to tackle additional tasks.

- **HR professionals should learn the basics of compensation.** Even though this book focuses on many of the issues they will need to be aware of in building a new compensation system, it is important to understand as much as possible about the field of compensation. At the end of this book, there is a list of resources, including textbooks, websites and educational seminars.

What is the bottom line? All compensation systems should have at least four main goals:

1. **Internal equity:** A clear definition of a job’s relative worth within a company.
2. **External market:** How competitive is the company compared to the outside labor market?
3. **Individual contributions recognized:** Does the compensation system pay employees fairly based on results, effort, education/experience, talent and overall job performance?
4. **Legal:** Does the compensation system adhere to major labor laws such as the Fair Labor Standards Act (FLSA), Americans with Disability Act (ADA) and other pay discrimination laws?