

Management Briefs



Investing in Employee Compensation: What's Your Compensation Philosophy?

First in a Series of Three Installments

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Many employers worry about their ability to retain and motivate employees during economic downturns and even downsizing. A sound compensation system can help by clarifying for employees the performance that will earn them greater rewards while driving the company's achievement of its strategic objectives.

Such a system is built on a platform that specifies the responsibilities of all parties (employees, managers, company owners), and it provides mutual benefits. Such a platform is characterized by:

- **A sound philosophy**—well-reasoned operating guidelines within which the compensation program is designed.
- **Internal equity**—pay levels consistent with the relative value of jobs.
- **External competitiveness**—pay levels sufficient to compete for and retain the talent your company needs.

In this first of a three-part series covering these characteristics, we will detail the process for developing a rational compensation philosophy and provide a model philosophy statement that incorporates the features discussed.

Establishing Your Compensation Philosophy

Most companies have a sense of what they value (i.e., what they are prepared to pay for), how to appropriately reward employees who demonstrate those values, and how to determine the appropriate pay for new employees, but usually the philosophy is not formally expressed. Management assumes the guidelines to be generally understood. Unfortunately, employees and managers often understand the guidelines differently, and even among management, interpretations may vary.

This leads to pay approaches that put both employees and managers at a disadvantage. For employees, their own role in driving growth is undefined (e.g., "No matter what I do, I'm going to get a three percent raise."). Managers often do not understand the various mechanisms they have available to them to reward performance (e.g., "How can I truly differentiate performance with only a three percent merit budget?").

As a result, the company is limited in its ability to use pay to encourage and focus behavior that is important to the success of the business.

Formalizing your compensation philosophy is a matter of defining the organization's unique operating conditions. To do this, your company's senior management needs to answer four key questions:

1. What is our business strategy and what are our goals? A clear statement of goals and strategy is the first step in determining what factors in performance should be rewarded and how (e.g., base salary, at-risk in-

centive pay—short-term or long-term).

2. What do we consider value-added contribution? State explicitly what your company is paying its employees for. Values may differ for different employee groups and may include any combination or all of the following:

- Performance.
- Competencies.
- Experience.
- Knowledge.
- Tenure.

3. Who are our competitors—for talent and business? Before you set pay levels, you need to identify the appropriate markets for the different types of employees you hire. Your competitive target levels (i.e., where you want to set your pay relative to your competitive market) may vary by employee group. For example, you may hire production and office clerical workers from your surrounding area. If there is an available talent pool, you may establish target pay at the 50th percentile of the local competitive market.

However, if you compete nationally for, say, design engineers, you may need to narrow the field to your industry. Since competition is apt to be stronger, you may decide to set your target pay higher—possibly at the 75th percentile of the pay of similarly skilled engineers within your industry.

4. What are our financial resources—our ability to pay? Knowing up front what you can afford will help determine not only pay levels, but pay delivery mechanisms as well. For example, you may need to pay the design engineers mentioned above at the 75th percentile of com-

petitors' pay, but you may be unable to provide the total amount as guaranteed base salary. You may opt instead to offer some pay contingent on both the company and the employee fully meeting their goals, and you may use a mix of fixed (base salary) and variable (bonuses and incentives) mechanisms for pay delivery.

Formalizing Your Compensation Philosophy Statement

Now you are positioned to begin the development of a meaningful statement of your company's compensation philosophy. This statement should include:

- Purpose of the plan (encourage and reward significant contributions to the success of the company).
- Definition of value-added contributions (performance).
- Pay delivery mechanisms (merit adjustments, incentives that would be defined fully in a separate plan document).
- Compensation action eligibility (performance appraisals, growth, promotion).
- Disclaimers (legal requirements and rights reserved by the company).

The time required to establish a compensation philosophy statement that reflects your company's unique operating conditions will yield rewards for employees, managers, and other stakeholders, as the preamble to a sound compensation program.

Remember the market-competitive position that you targeted as part of establishing your compensation philosophy? It will figure prominently in establishing equity and competitiveness, which will be discussed in the next two installments of this series.

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A Model Compensation Philosophy Statement

The following expresses the objectives of the company's compensation program regarding base salary. The company recognizes that all objectives may not be completely satisfied at all times for all employees, but they are set forth here to serve as guidelines along which proposed actions will be evaluated.

The company's objective is to encourage and reward significant contributions to its success. To that end, the company has established and maintains a competitive pay-for-performance compensation program as a component of its total rewards to employees and, to support this program, provides ongoing communications to its employees. The company's compensation program is designed to:

- Attract, hire, retain, and motivate qualified personnel.
- Pay for performance, providing faster salary growth through merit adjustments to those employees with higher levels of performance, as demonstrated through regular, fair, and objective performance appraisals.
- Provide short-term and long-term incentives for professional growth and opportunities for salary advancement and promotion on the basis of demonstrated individual performance.
- Ensure that salary levels are externally competitive within the company's competitive labor market(s), and internally consistent and fair.
- Attain the necessary balance in serving the interests of the company while, at the same time, giving proper consideration to the needs of employees.
- Be easily understood by individual employees, thus gaining their support and confidence.
- Be flexible and simple to administer.
- Meet all legal requirements in the administration of this compensation program; no consideration will be given to factors prohibited by law, such as gender, race, age, and disability.

The company has the right to amend, suspend, and/or terminate all or part of this plan at any time, and, if suspended or terminated, it may reinstate or modify all or part of the plan at any time without prior notification. The establishment and ongoing administration of this program does not confer any right to future employment. S

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