A sound compensation philosophy sets the stage for an organization's compensation program, providing the overall framework for plan design and administration. While the process of formulating the philosophy may seem clear, defining the right elements and integrating them into a cohesive document aligned with your business strategy can challenge even the most seasoned practitioners. Whether you are developing a new philosophy or validating an existing one, the answers to these ten questions will facilitate the process. Then your company will be better positioned to use rewards to drive business results.

Answer These Questions for a Sound Compensation Philosophy

by Stacey L. Kaplan

Developing a sound compensation philosophy seems like a relatively straightforward process; however, some compensation and benefits professionals struggle to complete this task. They identify the right components but fail to integrate them properly into a cohesive written statement of intent and direction. Progress also stalls when senior management resists the formalization process, not fully appreciating its value and the time commitment needed to gain consensus on the key elements of the philosophy. Yet, when linked to an organization's mission and vision, a well-articulated compensation philosophy drives organizational success by aligning pay and other rewards with business strategy. It provides the foundation for plan design and administration and anchors current and future plans to the company's culture and values. It provides the "why" when employees question compensation practices, thus serving as a helpful communication tool for reward determination.

A formal compensation philosophy is a means to an end, not the end itself. It is the springboard from which to create solid plan design. If you've been thinking about developing a compensation philosophy or updating your existing philosophy, answer these ten questions to facilitate the process.

What Are the Goals of the Compensation Plan?

Plan goals drive the design and administration of any compensation program. Since the philosophy provides the overall framework and starting point for plan design, articulate the plan goals up front and align them with your organization's business strategy, culture and values. It is imperative that you define the objectives of the compensation program and the measurable results you hope to achieve from your compensation expense. Senior leadership expects concrete results in terms of improved customer satisfaction, financials or reduced turnover as examples of added value to the company versus added cost.

Organizations often include a global phrase, such as "to attract, retain and motivate," as a stated program goal. While this may, indeed, be one of the driving forces behind your compensation program, challenge your executives to go beyond establishing generic plan goals and probe ways to differentiate your organization from others in your industry or locale. Identify the type of workforce and requisite skills needed to achieve your business strategy. Are there specific segments of the workforce you wish to focus on? For example, target individuals with specialized skills or those whose duties directly align with the corporate mission, such as nurses in a health care organization or customer-service experts.

There certainly may be multiple program goals, including those that articulate performance, financial ability to pay or importance of peer comparisons. Some organizations try to infuse creativity into their stated goals to bring them to life. When a steel producer stated it wanted to "hire five people to do the work of ten and pay them like seven," it went on record as a company embracing an above-market pay philosophy and strong corporate work ethic. The exhibit on page 37 describes examples of stated program goals from a cross section of industry representatives.

How Do You Define Compensation?

The term *compensation* evolved from a narrow context to a much broader definition. The traditional definition refers to direct pay and associated incentives, such as base salaries plus bonuses. Some organizations expand this definition to include benefits and perquisites, thus transforming compensation into *total compensation*. This definition more clearly recognizes rewards that are typically financial in nature, sometimes referred to as transactional rewards.

It is imperative that you define the objectives of the compensation program and the measurable results you hope to achieve from your compensation expense.

The metamorphosis continues with the advent of the *total rewards* package, which encompasses everything employees value in the relationship with their employer. Under a total rewards approach, the definition further broadens to include not only the transactional components of pay and benefits but also development and the work environment, often referred to as relational rewards. *Relational rewards* allow employers to differentiate themselves from their competition by offering rewards tailored to employee needs.

Regardless of how your organization chooses to define compensation, it is important to answer this question early in the process of developing a sound compensation philosophy.

With Whom Do You Compete for Talent?

Competition for talent crosses three lines: industry, geography and size. Industry plays an important role as a recruitment source, especially for high-level management and professional jobs. For example, a manufacturing firm seeks candidates from other manufacturers for jobs aligned to its core business, just as a university targets other organizations of higher education to fill academically-oriented jobs. However, both organizations likely target general industry across both the private and public sectors for information technology, human resources, legal and finance jobs. Focusing only on the core industry for jobs prevalent across all industries fails to capture the relevant marketplace.

From a geographic perspective, local, regional and even national markets apply, depending on the job. Just follow the typical rule: The higher the job, the broader the relevant marketplace. Management tends to recruit administrative and clerical staff locally but broadens the definition to the state, regional or national marketplace for top executives.

Finally, organizational size may be a relevant indicator when defining your marketplace. Measures such as revenue, assets or budget dollars help identify other comparable organizations with whom you may compete for talent.

What Is Your Targeted Competitive Position in the Market?

A fundamental decision in your compensation philosophy involves where to position your organization relative to the market. A middle-of-the-market approach targets the 50th percentile as the desired competitive rate, anchoring its structure around the market median. An organization striving to be a premium payer may target the 75th percentile, favoring an above-market structure.

An organization may target the at-market level for base pay and an alternative level, such as the 75th percentile, for total cash compensation. This implies that the incentive compensation program has significant upside potential so that, performance warranting, the organization would pay above-market rates.

Additionally, an organization may design its pay structure to lead or lag behind the market, depending on the timing of structure implementation and the point in time at which market data are aged.

Continued on next page

Regardless of the positioning strategy with respect to the market, it is important to recognize the variability of individual pay levels within a given structure, depending on factors such as skills, experience, tenure and performance.

Once a positioning strategy has been determined, benchmarking activities can commence to validate your competitiveness.

How Will You Balance Internal Equity Versus External Competitiveness?

In formulating a sound compensation philosophy, organizations define the role that the market plays in the design and administration of their compensation programs versus the role of internal equity. Over the past ten years, there has been a shift in emphasis toward external competitiveness, with many organizations embracing a market-based approach. They rely on market survey data to benchmark jobs, recognizing the role of supply and demand in affecting market rates. Although they are committed to paying the going rate, they also recognize the importance of fair and equitable treatment of existing employees. Thus, they struggle to balance internal equity with external competitiveness.

In the heyday of point factor plans, employers compared and contrasted jobs based on a variety of compensable factors, thus incorporating internal equity in the methodology before integrating market data. Today many organizations have abandoned those types of job evaluation plans in favor of less administratively cumbersome market pricing and whole job ranking approaches. Yet the issue of preserving internal equity usually exists.

"There needs to be a balance," said Carol Curtis, senior director of global compensation for Kelly Services, an international staffing solutions company headquartered in Troy, Michigan. "While market competitiveness is a critical factor, our compensation practices also reflect consideration of internal equity, to ensure consistency with our business strategy and objectives."

Companies need to decide philosophically whether to focus on external competitiveness versus internal equity or to attempt to maintain a balance between these two dynamics.

What Role Will Performance Play in Your Program, if Any?

Seniority versus performance? Which of these approaches will drive your compensation program? The answer to this question will influence current and future plan design and administration. If your organization adopts a pay-for-performance philosophy, then subsequent programs need to reinforce that culture. Here is an opportunity to synchronize your company mission, vision and values with your program goals and objectives, reflecting a performance-based culture. Under a bona fide pay-for-performance program, managers differentiate among higher and lower performers, making tough decisions on how to allocate their budget dollars fairly. Are you willing to forgo a pay increase for a ho-hum performer in favor of granting a better performer more money? How about granting a smaller raise to a satisfactory worker to free up salary dollars for a stellar performer? If so, you affirm principles supportive of a performance-based culture. In addition, organizations embracing this culture typically look less favorably upon across-the-board increases and cost-of-living adjustments.

Avoid disconnects between the business strategy and compensation philosophy. When the compensation philosophy articulates your organization's posture clearly and succinctly, then pay can motivate employees to drive organizational success.

Under a performance-based compensation philosophy, you must decide whether to recognize individual performance, group performance or a combination of both. Regardless, rewards will likely vary based on results, so be prepared to identify objective performance measures.

A performance focus need not be limited to pay programs. For example, some human resources administrators are designing programs that reward the employee population if their collective behavior yields lower health care costs. This may be applicable if your definition of compensation includes benefits.

What Will Be the Mix of Compensation?

In the context of pay, *mix* refers to the amount of the pay package that is fixed, such as base salaries, versus the amount that is variable or at risk, such as incentives. The use of variable pay has dramatically increased over the past decade across all industries. A recent salary budget survey confirmed that 79% of its participants use or were using some type of variable pay in 2006, up from 76% in 2005. Specialized, individual recognition awards rank as the most prevalent form of variable pay among the survey participants.

Variable pay encompasses a variety of options, from individual spot awards recognizing special achievement to group or individual incentive programs rewarding goal attainment. Referral bonuses and signing bonuses reflect other creative rewards under the variable pay umbrella. Philosophically, each organization must decide to what extent variable pay fits its culture and whether it should reward organizationwide results, individual achievements or both. This philosophy should align with the mission, vision and values of the organization. For example, if your company values teamwork and collective goal achievement, then incentive compensation plans should reward team performance at the corporate, regional or business-unit level. Avoid disconnects between the business strategy and compensation philosophy. When the compensation philosophy articulates your organization's posture clearly and succinctly, then pay can motivate employees to drive organizational success.

Organizations that embrace a total rewards philosophy expand the definition of *mix* to the allocation of the four components of rewards: pay, benefits, development and work environment. Where will you place your bets—in the transactional rewards of pay and benefits or in the relational rewards of development and work environment? Alternatively, will you trade off salary dollars for benefits? Some public sector organizations with rich retirement benefits and time-off policies embrace a compensation philosophy that lags behind the market on pay, but more than makes up for lower pay with a benefits package of substantial value.

A sound compensation philosophy articulates the roles and responsibilities of both line managers and human resources in the design and administration of a compensation program.

What Role Will Line Managers Play in Compensation Administration?

A sound compensation philosophy defines the role of line management from an administrative standpoint. Will you grant autonomy to business units to make compensation decisions regarding classifications, salary increases and promotions? Alternatively, will you centralize these functions within human resources? The extent to which you decentralize this decision making will not only influence the role of line management but also that of human resources.

Under the decentralized scenario, human resources serves as a consultant and trusted advisor to the business units. Business units authorize their managers to make compensation decisions, provided they adhere to their specific budgets and retain accountability for these decisions. Trust and accountability are the key enablers of a successful decentralized compensation program. Inherent in this approach is sufficient management training to ensure proper understanding of program guidelines and the consequences of a manager's decisions.

Increased globalization propels the need to address the centralized versus decentralized issue, because many organizations operating outside the United States need direction on the extent to which they can design or administer compensation programs. Many organizations choose to centralize policy development and decentralize administration, providing guidelines and guidance to managers overseas.

"We are having some interesting discussions about that right now, trying to determine the appropriate amount of local administrative flexibility within a policy framework that is developed centrally at the corporate level," Curtis said when asked about Kelly Services' posture on this issue.

Susan Cucuzza, director of human resources at Textron Inc.'s integrated supply chain organization, confirms an approach whereby individual business units authorize salary adjustments and classification changes within a framework developed by Textron's corporate compensation team.

"We operate autonomously with respect to salary administration, conforming to policy guidelines developed by our corporate headquarters in Providence, Rhode Island," Cucuzza said. "We serve as advisors to our line managers by providing tools and processes to ensure that job performance aligned with our business units' objectives is recognized and rewarded."

A sound compensation philosophy articulates the roles and responsibilities of both line managers and human resources in the design and administration of a compensation program.

What Will You Communicate to Your Employees?

Your compensation philosophy should express the extent to which you will communicate compensation practices to your employees. Organizational culture drives the decision to adopt either an open or closed communication model. Some organizations convey only the personal information pertinent to each individual employee, nothing more. This need-to-know approach translates into communicating information such as an employee's own salary range, grade, performance appraisal score and requirements for advancement. Under this scenario, it would be unlikely for employees to be privy to market data and the rationale for grade placement or pay increases. The aura of secrecy around compensation issues may create feelings of uncertainty or mistrust.

In an environment of open communication, employers adopt an approach whereby compensation information is transparent and openly shared. Organizations in the public sector often practice full disclosure and post many elements of the compensation program, such as entire job hierarchy, salary structure and even individual pay rates on the company Web site for public viewing. This liberal communication policy attempts to remove mystery from salary administration and demonstrate a fair and equitable compensation program. Often these intentions fail to materialize. Depending on an organization's culture, a very transparent communication policy may disenfranchise employees who cannot understand and accept the fact that pay differences exist for different reasons. Full disclosure without supportive facts and rationale risks employee alienation and mistrust.

Regardless of the extent to which you communicate program details to employees, a formal compensation philosophy serves as an important communication tool. It is especially critical in a total rewards environment due to the trade-offs among various components of the total package. While describing the strategic intent of the compensation program, a clear philosophy statement enhances employee understanding and trust.

To What Extent Should Senior Leadership Commit to the Compensation Philosophy?

This final question seems easy to answer but often goes unanswered because of the inability to obtain closure on the components of an organization's compensation philosophy. Without senior management's commitment to the compensation principles, the organization forfeits a significant opportunity to use rewards for strategic advantage and to drive organizational success.

One way to engage senior management in the discussion of compensation philosophy is to conduct individual interviews with key stakeholders early in the process. Once these key stakeholders provide input and points of view, assemble the executives in a group and facilitate discussion to gain consensus on the major components of the philosophy.

The extent to which senior management concurs with the proposed elements of your compensation philosophy drives

Continued on next page

the successful implementation of the compensation program. Senior leadership's commitment aligns current and future plan design and administration with the business strategy of your organization.

Final Thoughts

When answering these ten questions, step back and observe how the answers interrelate. For example, answers on performance relate to answers on mix, since variable pay often depends on a pay-for-performance strategy. Frequent communication enables the process—not only defining what employees need to know but also facilitating open channels with executives and managers. When all of the components integrate, the result is a sound compensation philosophy that helps you use rewards to drive business success. **B&C**

For information on ordering reprints of this article, call (888) 334-3327, option 4.

Exhibit

Sample Plan Goals: Excerpts From Compensation Philosophy Statements

- Attract and retain the highest performers.
- Pay market rates competitive at the 50th percentile for behavior that meets expectations and at the 75th percentile for behavior that exceeds expectations.
- Provide pay levels that are externally competitive among peers within our industry.
- Provide internal equity by considering differences in skill, effort, responsibility and working conditions among jobs.
- Adopt a total rewards package viewed as competitive by employees and flexible to accommodate changing business conditions.
- Provide compensation and benefits levels within our organization's financial ability to pay.
- Provide leadership among employers in our industry in implementing innovative approaches to total rewards.
- Provide flexibility to line managers to make compensation decisions within budgetary guidelines.
- Develop a consistent global framework that measures performance at the business-unit level.
- Encourage competency building by better linking career development, performance management and rewards.

References

"Creating a Pay Philosophy," Arthur Andersen Human Capital newsletter (September 2001).

"The Value of a Pay Strategy," Fox Lawson & Associates newsletter 11, no. 2. Brad Hill and Christine Tande, "New Rules: Paying for Performance," *Workspan,* (June 2006): 50-52.

Stacey Kaplan, "Total Rewards in Action: Developing a Total Rewards Strategy," *Benefits & Compensation Digest* (August 2005): 32-37.

Christopher Kelley and David Gustat, "Compensation Philosophy: The Starting Point not the Destination," *Workspan* (January 2006): 25-27.

Jason C. Kovac, "Salary Communication," WorldatWork white paper (November 2005).

Richard Payne, "Leveraging Pay to Deliver Value," Mercer Human Resource Consulting newsletter (November 4, 2005).

Terry Satterfield, "A Step-by-Step Approach to Developing an Effective Pay Philosophy," *ACA News* 42, no. 8 (September 1999).

Stacey L. Kaplan is managing principal of Diamond Consulting Group LLC, an independent human resources consulting practice in West Bloomfield, Michigan. She specializes in total rewards, performance management and general human resources consulting. She holds a bachelor's degree from Tufts University and a master's degree from Central Michigan University, as well as the certified compensation professional designation (CCP). She is an instructor for the International Foundation's Certificate in Compensation program.