



What Is Your Compensation Philosophy?

Considerations for Developing a Compensation Philosophy

If you have ever been a student in an Ethics class, you have probably explored the question "What is your philosophy of life?" In response, you may have had to ponder the question and pause while you gathered all the pieces that merge into the development of your personal philosophy. It is a big query which oftentimes generates more questions in the process of arriving at an answer.

In the work setting, you may have been asked a similar question, only pertaining to your compensation philosophy. Comparable to the process arriving at your personal philosophy, this seemingly simple question cannot be answered until multiple variables and factors are considered. This whitepaper will explore some of the strategic variables that need to be explored and considered when determining your organization's compensation philosophy.

Review External Factors That Might Impact Company Compensation Strategies

A compensation philosophy cannot be arrived at without reviewing external factors. Although we may want to put our blinders on and prefer to ignore the things going on outside our organization, it would be short-sighted to disregard. It is critical that external factors be monitored consistently and regularly. Some of the items that should be reviewed include:

- 1) Competitors' positions and threats
 - a) What are competitors' pay rates?
 - b) What types of compensation programs do competitors utilize, such as variable pay plans?
 - c) What types of compensation plans are typically utilized in the industry?
- 2) Business conditions
 - a) What is the state of the economy?
 - b) Will current technological changes affect our strategic plan?
 - c) What are unemployment rates and the size of the available labor pool?
 - d) Is it difficult to attract and retain employees?
 - e) How will the labor markets affect our strategy?
 - f) Does company geographical location have any effect on our plan?
 - g) Are there changing workforce demographics to consider?
 - h) How does the changing nature of the workforce affect our strategy?
 - i) Do international markets affect our strategy?
 - j) How will the legal and regulatory climate affect our strategy?

Examine Internal Business Needs and Issues

In order for a compensation philosophy to be successful, it must align with internal business strategies. Internal items that need to be reviewed include the corporate strategy, budget issues, short-term and long-term plans, and growth provisions. External factors reviewed in the previous step may also influence what will happen with respect to the internal business plan. Reviewing the following items will result in a thorough review of internal business needs and issues.





- 1) What changes in the company's compensation philosophy and practices will be required because of evolving corporate needs?
- 2) What needs to occur to ensure that compensation practices are in alignment with other HR practices and drive corporate strategy?
- 3) How can compensation be used to support critical business success factors?
- 4) Do performance appraisal systems and other related HR systems support both the compensation program and company business needs?
- 5) What are the company growth projections?
- 6) Is the company's organizational structure expected to change and how?
- 7) Will current staffing patterns support future needs?
- 8) Does the organization have specialized positions requiring skills that are not readily available in the market?
- 9) What new skills and types of employees will be required to promote future company success?
- 10) Is turnover an issue?
 - a) What are the turnover rates?

b) Are there turnover problems company-wide or are there specific departments or positions where turnover is a concern?

c) Is turnover linked to compensation issues?

- 11) Are employees dissatisfied with the compensation structure?
- 12) Does the company lead, lag, or match external market?
- 13) Is there a high or low level of trust among employees regarding pay practices?
- 14) Is the compensation philosophy communicated to employees and, if so, do employees understand the compensation philosophy?
- 15) What is the extent of involvement of managers/supervisors in the compensation process?a) What should it be?
 - b) How much control and flexibility should managers have?

Examine Current Compensation Policies and Practices

Once external and internal compensation practices have been reviewed and determined, it's time to compare and integrate the findings into the current compensation policies and practices. Depending on when your policies and practices have been reviewed, this process could result in starting from scratch rather than revising what already exists. A key factor in determining where you are going is knowing where you have been. You can then evaluate what has been successful and what areas may require more emphasis and direction than others. A careful discussion of the following questions will help you arrive at your current position.

- 1) What is the current company compensation philosophy (if any)?
 - a) Is there a different philosophy or practice for different positions?
 - b) Is there a different philosophy for executive or exempt employees than for nonexempts?
 - c) Are some positions (e.g., sales, IT) treated differently?
- 2) How are position pay rates/grades determined?
 - a) Is there a process established?
- 3) How and how often are pay rates/grades reviewed and adjusted?
 - a) What process is used?
 - b) Are salary surveys utilized?
 - c) Are pay rates/grades externally competitive?



- 4) How are new hire pay rates determined?
- 5) Is there a process to determine consistency and fairness in pay from employee to employee and to ensure there is internal equity among positions?
- 6) Are compensation practices and pay rates regularly examined for discrimination and equal pay issues?
- 7) Are adjustments or add-ons given based on cost-of-jobs in geographical locations?
- 8) Are incentives, bonuses or other variable pay used?
 a) What is the mix of base pay, bonus, incentives, and other rewards?
 b) Is any pay "at-risk" or are incentives and bonuses "add-ons?"
 9) How are pay changes determined?
- a) Is pay tied to: a performance measure? the performance appraisal system? cost of living changes? seniority?
- 10) Who determines pay changes? Who has the final authority?
- 11) Is a salary budgeting process in place?
- 12) Is a review of total employee compensation (e.g., benefits, perquisites) included in company compensation strategies?
 - a) Are benefits competitive?
- 13) Is there a strong non-monetary recognition and reward practice utilized?
- 14) Is compensation used strategically to support the company mission and business strategies?

What's Your Compensation Mix?

Compensation is not just a matter of determining base pay. The total compensation package may consist of multiple variables, depending on position and other factors. The type(s) of compensation for employee groups needs to be determined as appropriate. Forms of pay may include base pay, incentives, bonuses, profit sharing, skill based pay, stock, and automatic pay increases. Part of the total compensation package also includes benefit plans (e.g., insurance, paid leave, etc.), non-cash rewards, and other benefits such as tuition reimbursement, health club memberships, etc.

Some questions to ask include:

- 1) Why will variable pay be used? What is the reason for utilizing (or not utilizing) it?
- 2) If variable pay is used, can reliable measures and objective standards be implemented to ensure that it is effective and appropriately supports organizational needs?
- 3) Will pay be at-risk (i.e., some base pay is "at risk" in exchange for the opportunity for even greater rewards?) Or, are incentives, bonuses, etc., simply "add-ons" to base pay rates?
- 4) If pay is at-risk, what percentage is at-risk? How are different positions and employee groups treated? (i.e., companies generally put a much smaller percentage of pay at risk for nonexempt than exempt or managerial employees.)
- 5) What is the company "culture?"
 a) Is pay viewed as an "entitlement?"
 b) Is the organization very traditional or more entrepreneurial where risk taking is more accepted?
 c) Are employees and managers "ready" for and properly trained to handle significant

c) Are employees and managers "ready" for and properly trained to handle significant changes in the compensation program?



Examine Base Compensation Topics

The last step in determining your compensation philosophy is to review pay structure. The company needs to determine what their competitive position with regard to the market is – is the intent to pay at, above, or below "market?" Jobs will need to be evaluated including a process to ensure that jobs are both externally competitive and internally equitable. The following questions regarding pay structure and merit pay are important to consider:

1) Is a pay structure established?

a) What is the span or width of pay grades?

b) How do employees progress through the ranges?

2) How is merit pay utilized?

a) Is it tied to: performance? performance appraisals? skills? goals achieved? comparatios?

b) Is there an effective means to differentiate performance so that merit pay is meaningful?

c) Is merit pay effective in motivating employees?

d) Is there a meaningful distinction between exceptional, average, and below average performance?

e) How important is pay for performance?

f) Is there an organizational need to more closely align pay with performance?

g) What happens when an employee is at the top of his/her pay range? Above the pay range? Below the established pay range for the position?

h) How is pay compression handled? (i.e., when new or less experienced employees are hired at rates very similar to those of long term employees - so there is little differentiation between new and experienced employees.)

The benefits of establishing a compensation philosophy – and sticking to it – will provide a foundation for the organization in effectively managing its employee resources. It should be flexible enough to adapt to minor effects of market changes, but grounded enough to keep compensation in check with the company's overall strategic plan. In the end, both the organization and employees will benefit from having a compensation philosophy defined.

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