# Employee Compensation Basics

## Developing the Direct Pay Component of Total Compensation

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# Employee Compensation Basics

## Developing the Direct Pay Component of Total Compensation

Employees are compensated or rewarded in various ways for their participation in and contribution to the organizations that employ them. The combination of compensation and benefits granted to employees typically is referred to as total compensation. As illustrated in Figures 1 and 2 on page 3, compensation represents one of the three components of total rewards, and it is defined as an organization's costs that result in taxable cash income to the employee. For the most part, compensation is tax deductible for the organization that administers it. It includes:

- **Fixed pay,** which may be expressed in terms of an annual salary or an hourly wage, and may include shift or other differential pay.
- **Variable pay,** or pay at risk includes any form of compensation that depends on employee behavior or performance, such as commissions, bonuses, incentives and equity.

The primary objectives of compensation are to enable an organization to:

- Attract and retain the caliber of work force required to meet its mission and tactical plans.
- Motivate employees to operate at productivity levels that will allow it to achieve its objectives.

When a compensation system operates effectively, employee performance warrants the compensation provided by the organization, and each party derives a reasonable return on its "investment." Employers expect commitment from employees in the form of support for the organization, regular attendance and acceptable performance. In turn, employees expect the organization to reward them appropriately, and a key part of this reward is in the form of compensation.

When employees feel they are not compensated fairly, their commitment to the organization may decrease, their productivity may drop and, ultimately, they may choose to terminate their employment. Therefore, it is critical that employers keep compensation packages at appropriate and competitive levels.

1 Business Vision and Strategy

4 Salary Increases

2 Ideal Compensation Program Objectives

6 Looking Ahead

5 Evaluating Pay Programs

3 Setting Base Salaries

# 1 Business Vision and Strategy

Professionals who are entrusted with the design and delivery of compensation programs face the daunting, and sometimes paradoxical, challenges of ensuring that:

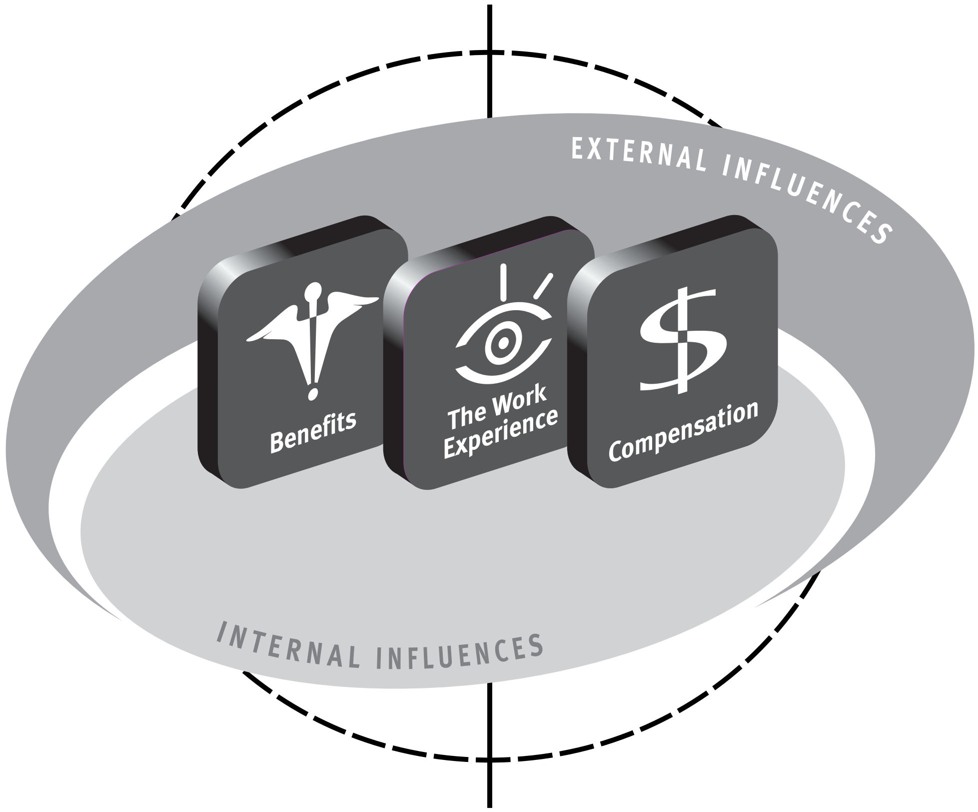
- Company costs are managed.
- Employee expectations are met.

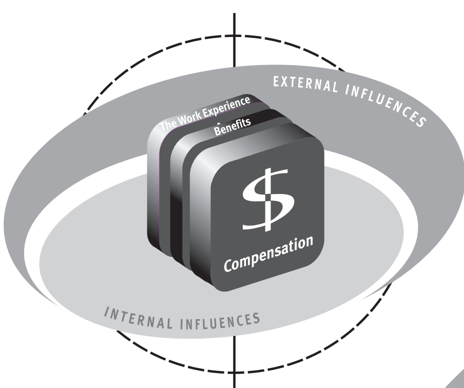
The starting point for the design of an organization's compensation program is its business vision and strategy. (See Figure 3 on page 4.) In turn, business strategy greatly influences human resources strategy. One of the outcomes of HR strategy is compensation strategy, which defines how people will be attracted, retained and motivated to ensure achievement of the organization's strategic goals and financial objectives. Compensation programs are a critical part of a firm's HR strategy because they can provide management with a powerful tool to meet customer needs by bringing about desired behaviors from employees.

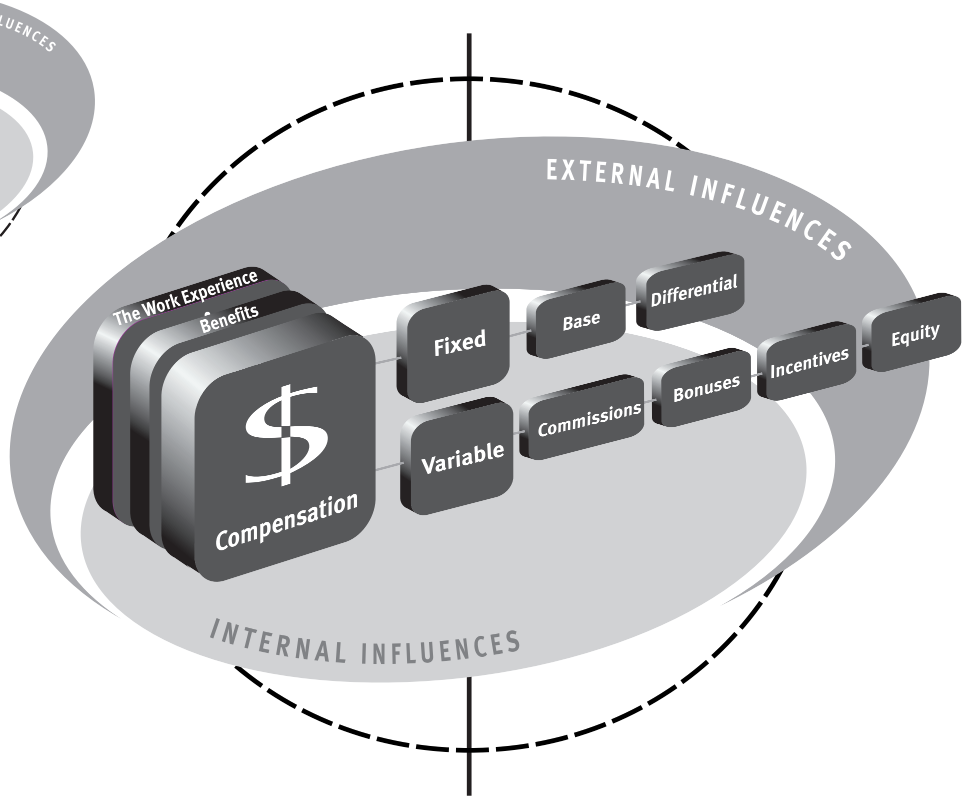
Once an organization has determined its approach to gaining a competitive business advantage, its compensation philosophy and pay program to support that strategy can be designed and administered. Several additional factors will impact the design of a typical compensation program:

- **External factors,** such as macroeconomic conditions, competitors' practices, governmental influences, customer needs, the global economy, demographic changes and changing social values.
- **Internal factors,** such as organization demographics, profitability and union contracts.

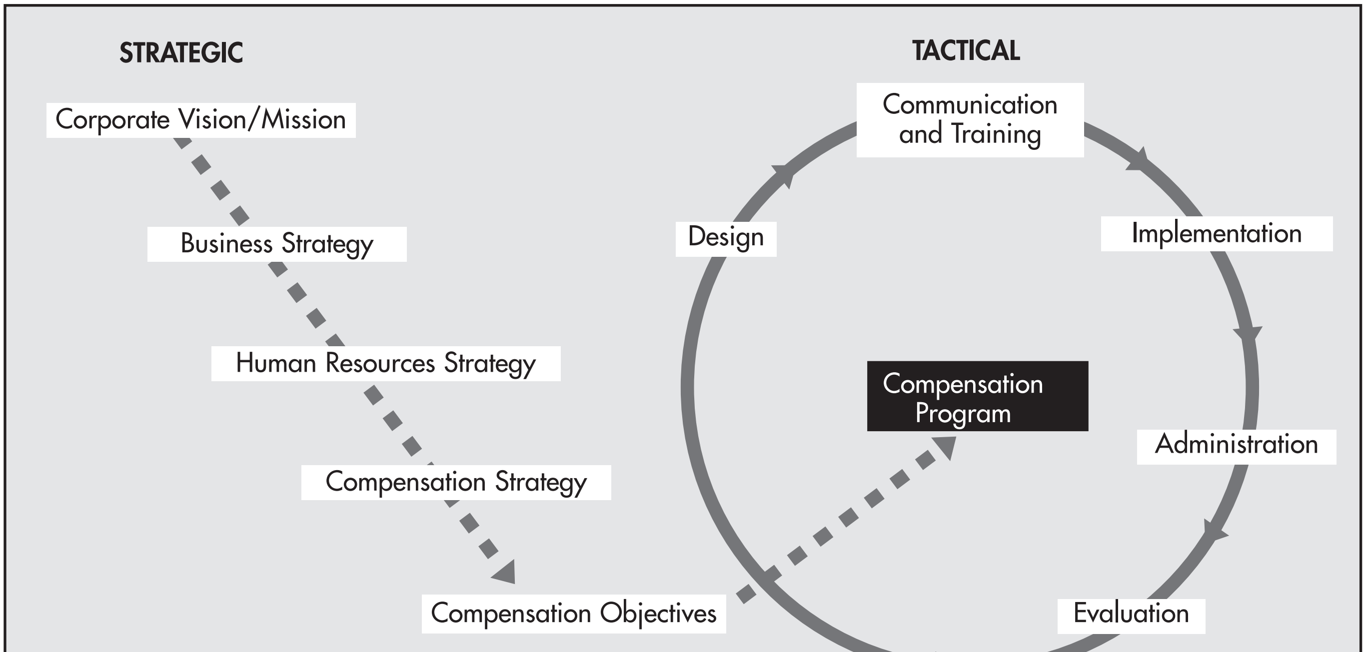
## Total Rewards Model and Compensation Sub-Models



## Figure 3: Relationship Between Organizational Strategy and the Compensation Program




Source: *Building Pay Structures: An Approach to Establishing the Foundation for a Compensation Program*, Building Blocks in Total Compensation, WorldatWork.

# 2 Ideal Compensation Program Objectives

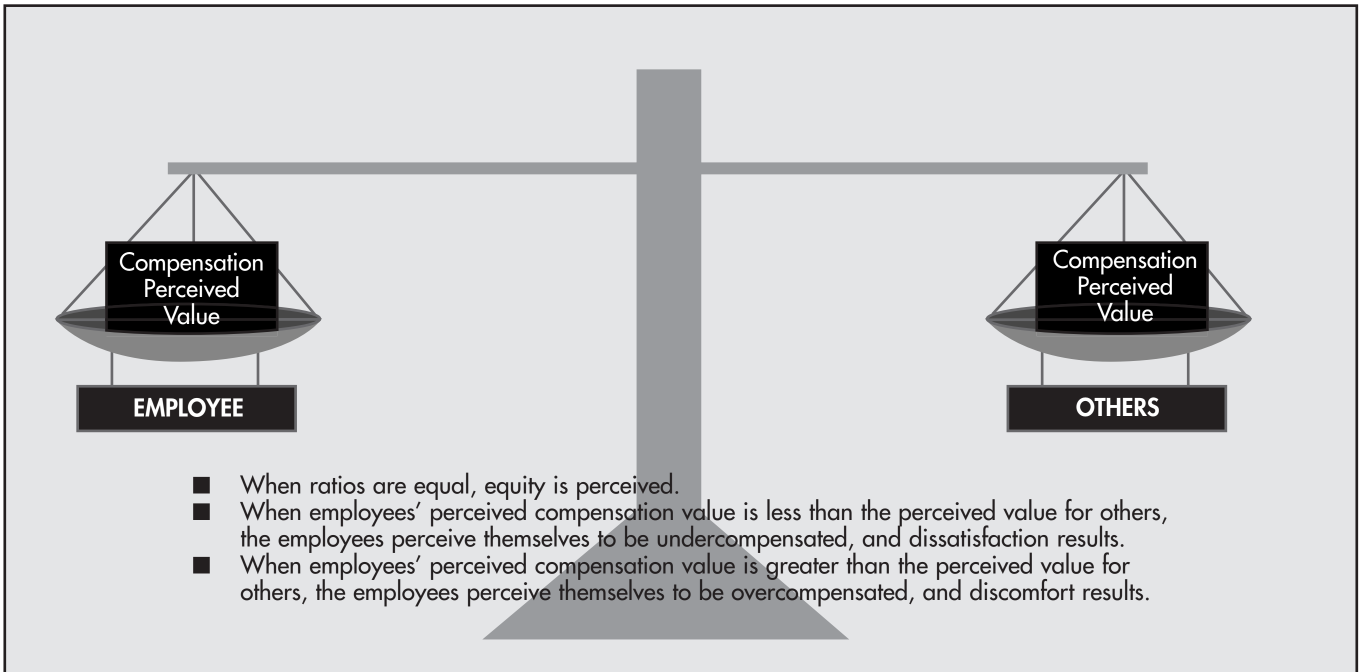
Once a compensation program is designed, it can be integrated with other total rewards elements such as employee benefits and elements of the work experience including acknowledgement, balance of work/life and development. Typically, responsibility falls to line management to oversee delivery of the compensation program. Effectively designed and delivered programs will bring about and reward team and individual behaviors that are supportive of business needs. At the same time, these programs will be cost-effective.

The following design objectives apply to the various forms of compensation, and they are referred to by most compensation professionals as the characteristics of an "ideal" compensation program:

- **Internally equitable.** Effectively designed compensation programs are perceived by most employees to be fair and consistent. (See Figure 4.) Because employees will weigh their contributions and compensation against the contributions and compensation of other people, there are two aspects of internal equity that must be managed:
  - Comparisons made among people in the *same* job.
  - Comparisons made among people in *different* jobs.

  Compensation practitioners can use carefully designed methods of performance management and

## Figure 4: Illustration of Equity Theory




Source: WorldatWork Certification Course C2

appraisal to address the first set of concerns. They can use logical, well-communicated methods of job evaluation to address the second set of concerns. Failure to achieve a satisfactory level of internal equity may result in employee dissatisfaction or discomfort as well as reduced performance.

- **Externally competitive.** Organizations that consistently pay wages below those prevailing in the marketplace may find it difficult to attract qualified employees in sufficient numbers and on a timely basis. Conversely, organizations that overpay could spend more than necessary on labor and experience a competitive disadvantage in the product market.

Compensation surveys provide data that identify competitive market rates that are paid by other organizations in a specific area for comparable jobs. This information can help identify what is necessary to pay to compete for talent in a given market. Keep in mind that employees read newspapers and collect data from other sources about the compensation levels of people who have jobs that are similar to theirs but who work for other organizations. If employees are to see their compensation as being fair and equitable, it must appear to be fair in comparison with the compensation of employees in other organizations as well as employees within their own organization.

## Figure 5: Regulation of Compensation

| LAWS/REGULATIONS | SCOPE/PROVISIONS | ADMINISTRATIVE AGENCIES |
|---|---|---|
| Railway Labor Act | Grants the right of nonmanagerial rail and airline employees in the private sector to bargain collectively with their employers on questions of wages, hours and work conditions | National Mediation Board<br>National Board of Adjustment |
| Davis-Bacon Act | Establishes wage and fringe-benefit standards for laborers and mechanics for federal public construction projects that exceed $2,000 | U.S. Department of Labor (DOL) |
| Walsh-Healey Public Contracts Act | Establishes wage, hour, overtime pay, child labor and safety standards for employees of manufacturers or suppliers of goods for federal contracts in excess of $10,000 | U.S. Department of Labor (DOL) |
| Fair Labor Standards Act (FLSA) | Deals with minimum wages, overtime pay, equal pay for both sexes, child labor and recordkeeping for employees engaged in interstate commerce or in production of goods for interstate commerce, or employed by an enterprise engaged in interstate commerce or production of goods for interstate commerce | U.S. Department of Labor (DOL) |
| Equal Pay Act (EPA) | Prohibits wage differentials based on sex for employees engaged in commerce or in production of goods for commerce, or who are employed by an enterprise engaged in commerce or production of goods for commerce | Equal Employment Opportunity Commission (EEOC) |
| Title VII of the Civil Rights Act (Equal Employment Opportunity Act) | Prohibits discrimination based on race, color, religion, sex, pregnancy or national origin for employers with 15 or more employees and whose business affects commerce; employment agencies; labor organizations engaged in an industry affecting commerce; the federal government; and the government of the District of Columbia | Equal Employment Opportunity Commission (EEOC) |
| Service Contract Act (SCA) | Establishes wage and fringe-benefit standards for employees of suppliers of services to the federal government in excess of $2,500 | U.S. Department of Labor (DOL) |
| National Foundation Arts and Humanities Act | Establishes wage and working-condition standards for professionals, laborers and mechanics directly engaged in working on projects receiving funding from the foundation | U.S. Department of Labor (DOL) |
| Age Discrimination in Employment Act (ADEA) | Prohibits job discrimination in hiring, firing or conditions of employment against individuals aged 40 or older for employers of 20 or more individuals, employment agencies and labor organizations | Equal Employment Opportunity Commission (EEOC) |
| Americans with Disabilities Act (ADA) | Prohibits discrimination against individuals with disabilities in employment, public services, public accommodations and telecommunications for employers with 15 or more workers | U.S. Department of Labor (DOL)<br>Equal Employment Opportunity Commission (EEOC)<br>Federal Communications Commission (FCC) |
| Civil Rights Act of 1991 | Establishes two standards of discrimination under Title VII: disparate treatment and disparate impact | Equal Employment Opportunity Commission (EEOC) |
| Internal Revenue Code | Defines deductibility and tax treatment of compensation for all employees and all employers | Internal Revenue Service (IRS) |
| Securities and Exchange Commission (SEC) regulations | Regulate plans that provide employer stock to participants for all publicly held companies | Securities and Exchange Commission (SEC) |
| State laws | Affect minimum wage, hours, overtime pay, discrimination and taxes for various employers | Vary by state |

The primary means for an organization to maintain pay credibility and promote a perception of fairness and equity among employees is to use surveys and make changes when unacceptable variances arise.

- **Affordable.** When designing a compensation program, one of the first questions that must be addressed is, "Is it affordable?" To answer that question, an organization should look at the external and internal business environment along with its financial circumstances. Gathering data is key to being able to predict the business outcome of a compensation investment.

- **Legally defensible.** Compensation programs increasingly have become regulated over the years, and they must comply with existing government regulations. Figure 5 highlights the major laws affecting compensation as well as the principal agencies that issue regulations and monitor for compliance.

  Compensation professionals should stay up to date with government regulations and their interpretations, and they should seek technical or legal counsel when necessary to ensure that compensation programs are legally defensible *before* they are introduced. Penalties to employers who intentionally or unintentionally violate statutes and regulations can be substantial, not only in financial costs but also in terms of credibility with employees, customers and the general public.

- **Understandable and saleable.** The most elegantly designed compensation program will not achieve its objectives unless managers and employees understand and, ultimately, buy into the program. Therefore, effectively communicating the program is an important component in the development and implementation of the program. To ensure understanding, a program should be communicated using terms the audience understands. For example, reliance on the technical terminology of the compensation discipline when explaining the program to line managers will not ensure understanding. Remember, it is line managers who will have to deliver the program to their employees.

  A formal communication program should include information about the compensation process and how this relates to the corporate philosophy or mission. The following six subjects should be included in any communication of a compensation program's objectives:

  - Methods used for job analysis and job evaluation.
  - Organizational policy with respect to matching the market on pay levels.
  - Role of performance and performance appraisal in determining individual pay.
  - Pay-increase policy and administration.
  - Effects of governmental and/or economic constraints on the amount of money available for compensation purposes.
  - Pay policies and regulations used in compensation administration on a day-to-day basis.

  Because achieving a fair and equitable compensation program requires active involvement and feedback from managers and employees, it is important that they understand the program. When a program is communicated openly and clearly, employees will understand that it is based on fact and should not be impacted by whim or manager biases.

- **Efficient to administer.** Compensation programs can assist managers in making better decisions about pay and rewards, and properly designed programs can help managers achieve their business objectives. Rather than serving as goal-directed tools, however, compensation programs often degenerate into bureaucratic burdens that become ends unto themselves. As a result, line managers may complain that compensation management is more of a hindrance than a help.

  It is important that administration of an organization's compensation program be as simple and straightforward as possible. Otherwise, the program may be misused, and numerous exceptions may be made to policy, making efficient administration impossible.

***Pay programs should be designed to protect an organization from awarding excessive compensation levels. At the same time, employees who contribute as the organization expects should be compensated accordingly.***

- **Protective of organizational resources.** Because no organization has unlimited resources, it is important that all organizational resources be used wisely, including the financial resources necessary to fund the compensation program. Therefore, pay programs should be designed to protect an organization from awarding excessive compensation levels. At the same time, employees who contribute as the organization expects should be compensated accordingly. Those who cannot contribute in their current position may have to find another position or organization, where their skills can be used to greater advantage.

  Remember that employees are the primary reason an organization is able to remain competitive. They should be seen as an investment that should be protected as well as maximized.

- **Capable of being tailored and reshaped.** Business plans are flexible and continually undergoing change. The same should be true for compensation programs. Organizations should be able to adjust their compensation programs as external and internal conditions change.
  This requires that compensation programs be flexible enough to allow timely, gradual and ongoing tailoring.

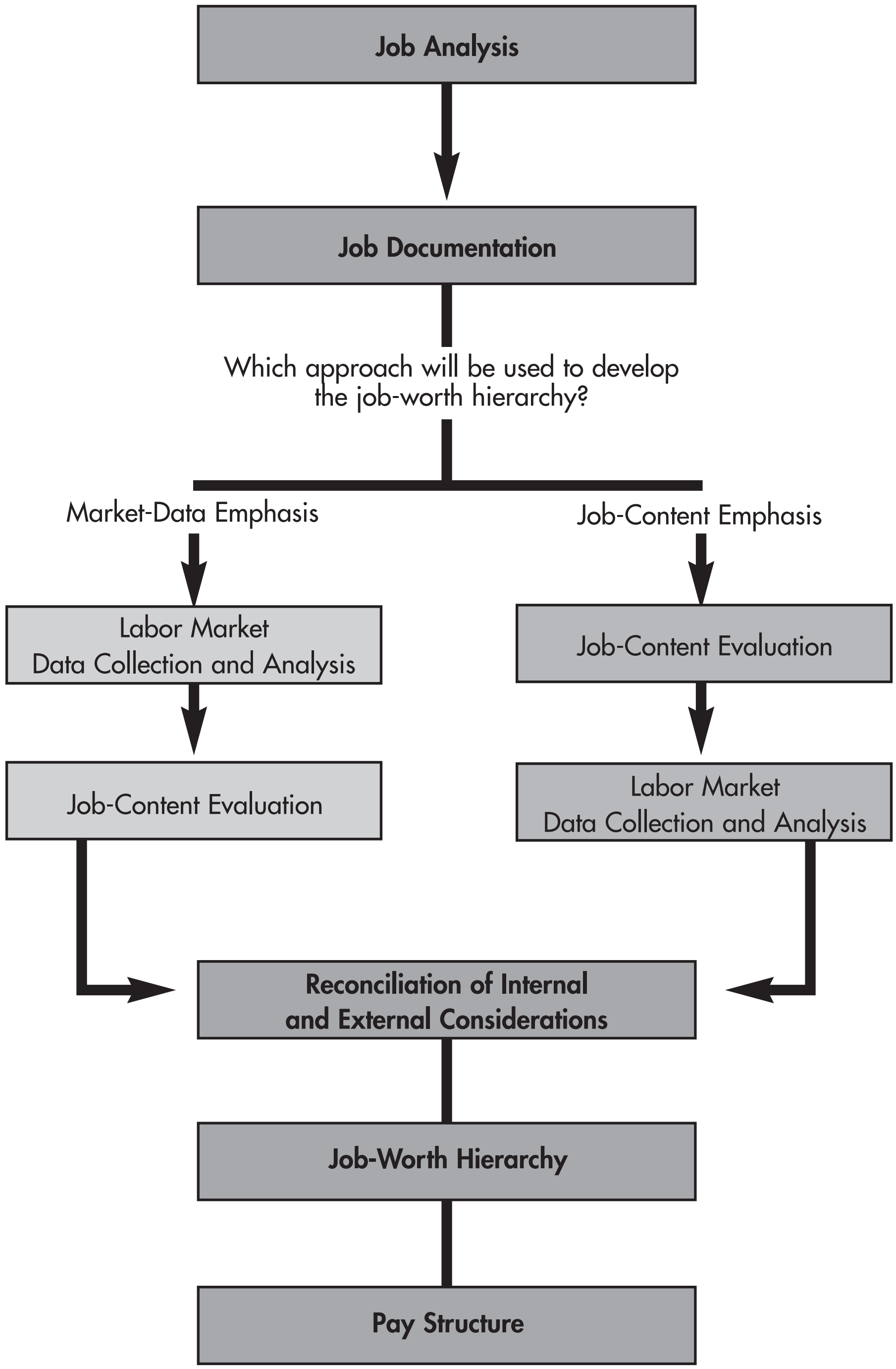
- **Appropriate.** Each organization is unique within its own industry or geographical area. When a compensation program is designed, unique characteristics need to be identified and taken into consideration. An effective program cannot be designed without taking into account the nature of the organization, its business strategies and all other management processes.

No compensation program can be designed that fully and continually will meet all of the "ideal" compensation program objectives. However, organizations should strive to achieve the goal of continually improving their compensation programs.

# 3 Setting Base Salaries

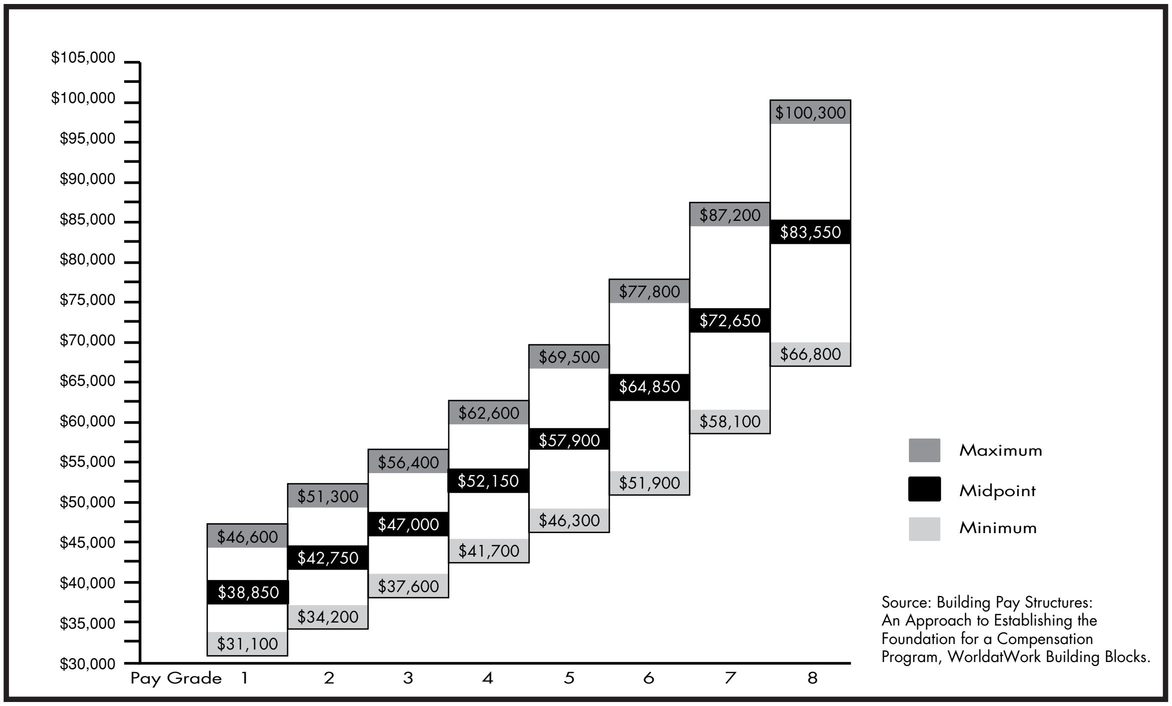
The first step in determining base salaries is to establish a job-worth hierarchy. As illustrated in Figure 6, establishing a job-worth hierarchy starts with job analysis, which is the process of determining and defining the content of jobs. This may be accomplished through techniques such as job observation, employee interviews and questionnaires. This process often leads to the production of job documentation, such as formal, written job descriptions.

## Figure 6: Establishing a Job-Worth Hierarchy




Source: WorldatWork Certification Course C2

## Figure 7: Illustration of a Pay Structure




### Job Evaluation

Once job analysis has been conducted, it is possible to perform job evaluation, which is the process of determining the worth of jobs in the organization relative to other jobs, principally to distinguish wages or salaries paid. Job evaluation can be performed using either a market-pricing emphasis or a job-content emphasis. Regardless of whether a market-pricing or job-content approach is used for job evaluation, the other approach should be used as a check.

Market pricing is the process of analyzing salary survey data to establish the worth of jobs as represented by their dollar value. Jobs for which no market data is available may be "slotted" into the job-worth hierarchy near comparable jobs for which data is available. It must be noted that if it is used in isolation, market pricing is not an acceptable job-evaluation approach in jurisdictions that have "pay equity" or "comparable worth" laws.

Job-content evaluation involves analyzing each job in an organization and then assigning each job a place in the hierarchy that reflects its value relative to the perceived value of other jobs. The difficulty of methods ranges from simple job ranking to more complex computer modeling involving regression analysis of compensable factors, which are intrinsic elements in jobs that add value to the organization. Factors that measure "skill," "effort," "responsibility" and "working conditions" are used most commonly in quantitative job-evaluation systems.

There is an important philosophical distinction between market pricing and job-content evaluation. When jobs are market priced, it is the market rather than the organization that determines pay philosophy. When job-content evaluation is used, job value is more reflective of the organization's internal philosophy and value orientation.

### Building Pay Structures

A job-worth hierarchy may be used to establish a pay structure, which is the foundation of most compensation programs. In simple terms, pay structures are job hierarchies with pay rates and/or pay ranges assigned. The assumption in the construction and use of pay structures is that the greater the worth of the job – as determined by job-content and labor-market analysis – the higher its pay grade and range. (See Figure 7.)

Typically, there are three key reference points within each pay range: the minimum, midpoint and maximum. The midpoint, or middle pay value for the range, usually represents the competitive market value

***Pay-rate differences for individuals are not necessarily desirable for each job. For instance, when all employees work essentially under the same standards, single pay rates may make sense.***

for a job or group of jobs. An organization's base-pay policy line connects the midpoints of the various pay ranges in the pay structure.

Some organizations have consolidated the numerous grades characteristic of traditional pay structures. The use of fewer broad "bands" instead of narrower pay grades better reflects a streamlined, flatter job-worth hierarchy.

Regardless of the methodology used for their development, pay structures ultimately are determined by:

- **Internal equity,** or judgment as to the relative internal worth of the job's content.
- **External competitiveness,** or market rates for comparable jobs.

Organizations may emphasize one factor over another, but there will be a balancing and blending of the two to meet an organization's overall compensation objectives.

### Setting Salaries

Every organization needs a defined system for setting pay within a pay range for each individual who holds a job in each salary grade. Determining how much to pay an individual is in many respects more complex than setting the correct salary grade for each job.

The purpose of pricing jobs usually is thought of in terms of ensuring that the pay of current employees is sufficient so that it is not a major cause of turnover. However, there is another purpose: to ensure that the organization is competitive while recruiting new employees.

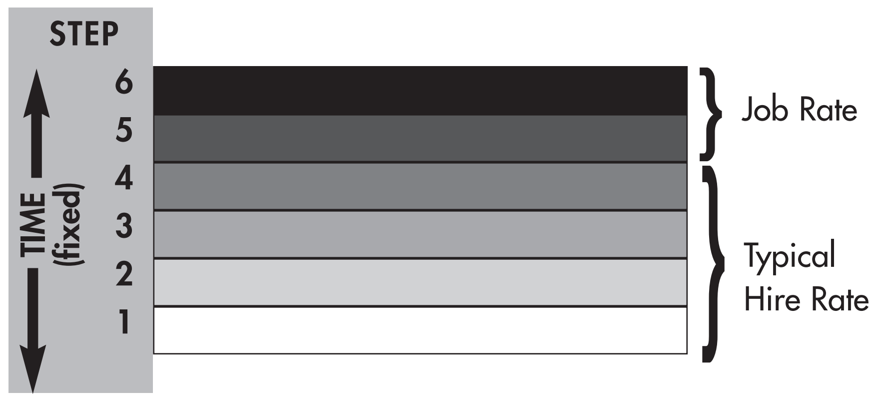
Once pay ranges have been established, most organizations have a policy of paying new hires, who generally have minimum qualifications for their jobs, at or near a range minimum. This practice keeps an organization from paying new hires at rates that are too close to those paid to more experienced employees in the same job. Individuals with experience frequently are hired at higher pay rates.

Sometimes, because of market conditions, new hires with relatively little experience must be paid substantially above the range minimums. Internal-equity concerns created by such situations will need to be addressed. One such concern is compression, which refers to situations where pay differentials among employees are too small to be considered equitable.

Note that pay-rate differences for individuals are not necessarily desirable for each job. For instance, when all employees work essentially under the same standards, single pay rates may make sense. Single rates frequently are paid when there is a short learning time for a particular job. They also apply in automated work or where an assembly line controls the pace of work. Under these circumstances, varied salaries could result in the organization paying a premium for no purpose or penalizing some employees for no reason. Employees who believe in the equity standard of "equal pay for equal work" would view such pay variations as favoritism.

Single rates do not apply only to lower-paid positions. For instance, at a given airline, all pilots (captains) are paid the same as long as they fly the same equipment and are qualified. Even at airlines that have negotiated a two-tiered system, there are only two rates of pay for qualified captains flying a particular type of plane. Which rate is received depends on whether the individual was hired before or after the two-tiered system was introduced.

## Figure 8: "Step Rate – Automatic" Approach to Within-Range Increases




Source: WorldatWork Certification Course C4

# 4 Salary Increases

Any salary-increase policy should address the following questions:

- Should employees as a group be granted a general increase from time to time?
- Which factors should management consider while determining individual pay within each range?
- What pay action should be taken in the event of a promotion?

An overview of various types of pay increases will help provide answers to these questions.

### General Increases

General, or across-the-board, pay increases are granted to all employees or to a group or class of employees. These increases may be expressed in terms of dollars or as a percentage of base salary. For example, a group of office workers might receive increases of 30 cents an hour, or they may receive 4 percent of current pay.

General increases are designed to ensure that employees' pay keeps pace with the pay of peers in the labor market. When a company grants a general increase, it is paying more for essentially the same level of performance. Higher compensation costs must be matched by improvement in productivity, passed on to customers in the form of higher prices or absorbed, resulting in lower profits.

Note that increases in payroll costs are not different from rising costs of energy, materials or supplies. However, a critical management role is to manage the spread between revenues and costs. If a company grants general pay increases linked to market inflation, then maintaining the spread between revenues and costs must be managed by methods other than the containment of pay increases. Managers often have concerns about general increases that automatically are tied to economic factors; they usually would prefer to have at least some flexibility in the choice of

## Figure 9: "Step Rate – Variable" Approach to Within-Range Increases

| PERFORMANCE RATING | PAY ACTION |
|---|---|
| Outstanding | Two-step increase |
| Expected | One-step increase |
| Marginal | Zero-step or one-step increase with delay |
| Unacceptable | Placed on probation, demoted or terminated |

factors, such as performance, to be considered in determining the amount of the increase. Because general increases are not conceptually compatible with pay-for-performance programs, their use has diminished as performance-based programs have expanded.

#### Cost-of-Living Increases

A cost-of-living increase is a specific type of general increase. Cost-of-living allowance (COLA) increases are intended to protect employees' purchasing power against erosion caused by inflation. One perceived drawback of COLAs is that they can contribute to inflation and cause employees to fall further behind in real earnings. Furthermore, there is no true measure of the "cost of living." The U.S. Bureau of Labor Statistics publishes the Consumer Price Index (CPI), which is an index of changes in the prices of goods and services in a market basket. The market basket is based upon goods and services typically purchased by a family of four of a semiskilled factory worker, where the head of the household is the only family worker. The CPI is a useful measure for economic purposes and as an input to compensation planning and administration. However, the data do not measure cost of living; instead, they measure changes in the prices paid for goods and services for a particular style of living. It must be remembered that the CPI and an index of wage levels are different, and they do not necessarily move together.

### Within-Range Increases

Within-range increases are base-pay increases that move employees forward in the pay ranges assigned to their jobs. Within-range increases usually are determined by some combination of the employees' length of service and performance. The two principal types of within-range increases are step increases and merit increases.

#### Step Increases

With step increases, pay ranges are divided into a number of pay rates, or steps, and increases are based primarily on length of service, although differences in performance also may be reflected. Although this concept most commonly is used for nonexempt employees, it sometimes is used for professionals such as accountants, lawyers and engineers. There are several different approaches:

- **Based on length of service only.** Under this approach, an employee receives, on a fixed time schedule, single-step increases up to the range maximum, which is usually at or just above the competitive job rate. (See Figure 8.) This type of increase is commonly known as "step rate – automatic." If performance is unsatisfactory, the increase is denied, and probation, demotion or dismissal may result.

- **Based on length of service and performance.** This type of approach commonly is referred to as "step rate – variable." Figure 9 illustrates one approach to this type of increase.

There are other variations of the step-increase concept. One is to

## Figure 10: Merit-Increase Matrix Based on Performance Only

| Performance Rating | Fixed-Increase Amount | Discretionary-Increase Range |
|---|---|---|
| Outstanding | 7% | 6-8% |
| Consistently exceeds standards | 5% | 4-6% |
| Meets standards | 3% | 2-4% |
| Does not fully meet standards | 2% | 0-2% |

have two or three performance tracks through which an employee progresses to a performance-zone maximum. Differences in pay based on variations in performance can be accentuated by adding timing differences to the individual performance tracks.

Another variation of the step-increase concept uses increases based primarily on skill and commonly is referred to as "skill-based pay." The determining factor here is not time or performance but skill mastery. The number of steps is determined by the number of relevant skills or skill sets required to perform a job or set of jobs. Typically, the increase is given upon acknowledgment by the employee's peers or management that the required skills for that level have been mastered. However, some organizations pay only when an employee actually *uses* the skill or skills. Skill-based pay facilitates flexible job assignments that allow employees to be interchanged as needed, and it encourages employees to continue broadening their skills.

An emerging concept is competency-based pay, which bases increases on the development of individual "competencies" identified by an organization as critical to its success.

### Merit Increases

Increases based on merit are designed to relate differences in pay for the same job to differences in work performance. A merit system usually is based on a matrix of pay-increase percentages for varying levels of performance. (See Figure 10.) Variations in the basic approach to merit pay include use of:

- Position in range in addition to performance.
- Variable timing in addition to performance and position in range.

These variations are illustrated in Figures 11 and 12.

The philosophy underlying most merit pay systems is that employees' job performance will determine how fast and how far employees move through their pay ranges.

Most organizations consider the individual's performance and current position in the pay range when determining merit increases. As a result, merit increases may vary both in size and timing. Many organizations vary the size of merit increases but use a fixed frequency. (See Figures 10 and 11.) The most typical frequency is 12 months, although it may vary by job level. Timing of increases may be based on:

- Calendar or fiscal year.
- Service-anniversary date.
- Previous increase date.

Some organizations vary both the size and frequency of the merit increase, while others vary the frequency but fix the size. (See Figure 12.)

## Figure 11: Merit-Increase Matrix Based on Performance and Position in Range
FIXED TIMING

| Performance Rating | Position in Range Before Increase: First Quartile | Second Quartile | Third Quartile | Fourth Quartile |
|---|---|---|---|---|
| Outstanding | 9% | 7% | 5% | 3% |
| Consistently exceeds standards | 7% | 5% | 3% | 0% |
| Meets standards | 5% | 3% | 0% | 0% |
| Needs improvement | 2% | 0% | 0% | 0% |
| Unsatisfactory or too new to be rated | 0% | 0% | 0% | 0% |

## Figure 12: Merit-Increase Matrix Based on Performance and Position in Range
VARIABLE TIMING

| Performance Rating | Position in Range Before Increase: First Quartile | Second Quartile | Third Quartile | Fourth Quartile |
|---|---|---|---|---|
| Outstanding | 7% (6-9 months) | 5% (9-12 months) | 4% (12 months) | 3% (12-15 months) |
| Consistently exceeds standards | 5% (8-10 months) | 4% (10-12 months) | 3% (12-15 months) | 2% (15-18 months) |
| Meets standards | 4% (9-12 months) | 3% (12-15 months) | 2% (15-18 months) | 0% |
| Needs improvement | 2% (12 months) | 0% | 0% | 0% |
| Unsatisfactory or too new to be rated | 0% | 0% | 0% | 0% |

## Figure 13: Success Factors for Performance-Based Pay-Increase Programs

### Success Factors

- There must be measurable differences in individual job performance.
- Performance differences must be significant enough to merit the time and effort required to measure them.
- The organization's performance-appraisal program must be sound and perceived as fair by employees.
- Supervisors and managers must be trained in employee-performance planning and appraisal.
- Pay ranges must be of sufficient width to allow for adequate differentiation of pay based on performance.
- An organization's linkage of pay to performance must be sound, and it must be recognized and understood by employees.
- There must be trust between supervisors and subordinates.
- Management must be committed and willing to make distinctions between employees based on performance.

The typical size of a merit increase varies directly with an individual's performance – employees who perform better will receive larger merit increases. However, employees who are higher in their pay ranges will receive smaller percentage increases expressed in terms of their base pay.

A final variation on the above methods may involve either merit or step increases to the range midpoint, followed by lump-sum bonuses that vary in amount depending on performance. Theoretically, the employee must "re-earn" the bonus by repeating performance above standard. Unlike pay increases, lump-sum bonuses do not affect base salary, so high performers do not realize the year-to-year compounding effect that can add considerable expense to an organization's compensation program.

While there are many other variations of these pay-increase approaches, all known variations of within-range pay increases represent a combination of the two basic approaches: step and merit increases.

### Pay for Performance: Success Factors

The conditions that must be fulfilled for a performance-based pay-increase program to be successful are listed in Figure 13. While this list is not intended to be exhaustive, it does provide the major factors that will affect the success of a merit pay program.

Improved performance should result in greater employee productivity, which in turn should result in improved business results. Therefore, a performance-based pay-increase program that results in improved employee performance also should result in improved business performance. This type of program, however, is complex to administer and requires difficult management decisions.

Organizations need to ensure that their performance-based pay programs measure performance as objectively as possible because a primary problem is likely to be the appropriate determination of performance. Management should evaluate performance and make judgments regarding pay differentials diligently. Everyone involved in this process needs to make significant commitments of time and effort if the performance-based pay program is to succeed.

## Figure 14: Characteristics of an Effective Performance-Appraisal System

### Characteristics

- Criteria are as objective and quantifiable as possible so that varying interpretations by different reviewers are minimized.
- Performance appraisal is based on direct measurement of job-related results as opposed to employee personality traits. Only behavior that affects job results is considered.
- Each performance criterion is weighted for relative importance.
- Performance standards are established for various levels of employee performance.
- Performance criteria and standards are communicated to the employee at the beginning of the appraisal period, and they are reviewed and updated periodically for timeliness and relevance.
- Supervisors and managers are trained in the concepts and process involved in appraising performance.
- Appraisals are conducted by people such as direct supervisors, who are knowledgeable about employees' performance.
- Appraisals are committed to writing and reviewed with the employee.
- Employees have access to an "appeals" mechanism to reconcile differences between the employee and supervisor.
- The appraisal instrument and methodology are reviewed periodically, providing opportunities to identify and eliminate potential problems and to make improvements.

## Performance-Appraisal Considerations

If a performance-based pay system is to meet its objectives, a well-designed and properly administered performance-appraisal system must exist. An effective performance-appraisal system should have the characteristics listed in Figure 14.

## Promotion Increases

Promotion increases are pay increases granted to employees who are promoted from one job to another job with higher value to the organization. Promotions are defined in two ways:

- **Organization promotions** involve a change in the nature of the work, usually from a nonsupervisory to a supervisory position or to a significantly different type of supervisory responsibility. There will be a noticeable change in the level of accountability. An example is a promotion from specialist to supervisor, or from supervisor to manager.
- **Growth or job-family promotions** result from recognition that an employee has grown within his or her job, and growth is likely to continue. In this situation, the employee stays in the same job family but assumes additional duties and responsibilities. The promotion is made after the employee demonstrates the ability to meet the performance standards of the higher position. An example is a promotion from secretary to senior secretary, or from engineer to senior engineer.

The size of a promotional increase is influenced by a number of factors, including:

- The magnitude of the promotion, as measured by the difference between the pay ranges assigned to the old and new jobs.
- An employee's salary position within the range for the new job.
- Existing pay relationships among the promoted employee's peers, superiors and subordinates.

**Figure 15: Elements of a Pay Program That Should Be Audited**

| Elements | |
|---|---|
| ■ Compensation strategy | ■ Pay structures |
| ■ Pay policies | ■ Performance evaluation |
| ■ Job design, descriptions and specifications | ■ Individual pay decisions |
| ■ Job-evaluation plans | ■ Administrative procedures |
| ■ Job pricing | |

# 5 Evaluating Pay Programs

While compensation represents a major cost of doing business for most organizations, little, if anything, is done by most organizations to assess how their pay programs are working.

A properly designed audit amounts to a performance appraisal of the pay program. It is intended to determine if a program is effective, efficient and appropriate for an organization at a given time and in a given context. Because an audit is an excellent planning tool, it can provide input to strategy revision and should be planned as an ongoing activity.

Auditing is critical from an ongoing business standpoint and also from a *legal* standpoint. An audit should be designed to

- Determine if the pay program is meeting the objectives established by management.
- Establish that the pay program is being administered according to standard employer policies and procedures.
- Reduce the risk of challenge to the pay program from employees, government agencies or other third parties.
- Improve understanding of the roles and responsibilities of human resources professionals and line managers in administration of the pay program.
- Improve internal communications and understanding of the pay program.
- Provide information for future program enhancements or modifications.

Audits of an organization's compensation program should not be put off until there is a complaint. An annual cursory review of major pay program components should be performed to ensure that the program is meeting the needs of the organization. Furthermore, a detailed review of targeted program components should be performed at least every other year. The elements of the pay program that should be evaluated are listed in Figure 15.

Auditors need to be objective and impartial. Ideally, they should be disinterested parties with no stake in a particular outcome. In addition to understanding audit principles and processes, they should possess well-developed analytical, writing and interpersonal skills.

While auditors can examine internal and external records and reports such as personnel records, payroll data, pay-survey data, accounting records and compensation data bases, an audit cannot be based only on statistical measures. It also is important to gather qualitative data about the level of understanding various parties have of the pay program and how they view it. Interviews and focus groups can be used effectively to make these determinations.

Once data have been gathered and analyzed, findings and recommendations can be developed. A report should be prepared that presents findings in an unbiased manner and provides adequate information to give readers a proper perspective. If a problem is identified, an appropriate course of action can be negotiated to correct the problem. An audit can show where the pay program is successful in meeting objectives and where it is falling short. Perhaps most important, it can provide the best basis for changes to an existing program, and it can identify the need for new approaches.

# 6 Looking Ahead

The challenges and opportunities for those responsible for the design and delivery of the pay systems are numerous and exciting. Consider the following critical factors that will shape the future of organization's direct reward systems:

- **Constraints in operating costs.** Most economic indicators in the United States, Canada and other developed countries portend an extended period of slow growth and increased competition. The need to control labor costs will continue and intensify, requiring compensation programs that ensure that the fewer available compensation dollars are funneled to those who are most deserving.

- **Re-engineered organizations with an emphasis on teams.** Re-engineered organizations will change the way work is accomplished, relationships among employees, speed and openness of business communications, and the manner in which monetary rewards are allocated. An overall movement toward teams will necessitate more rewards for group performance in lieu of individual recognition, challenging not only past practice in most organizations but also long-held views of individualism and competition. Compensation professionals face the challenge of designing compensation programs that bring about an appropriate balance of individual and team rewards.

- **Use of "contingent" employees.** There is an increased prevalence of workers under short-term contracts, part-time employees, temporary employees and dedicated consultants. Compensation professionals will be called upon to assist in the development of pay systems for this new breed of contingent employee. If pay systems for this type of employee are not managed carefully, any cost reductions achieved through the replacement of permanent, full-time employees may be squandered quickly.

- **Empowerment of line managers.** It will be incumbent upon compensation professionals to design programs that are easily understood and flexible enough to allow enlightened line managers to use appropriate discretion when allocating economic rewards. With fewer technical, expert resources available to the compensation function, organizations will rely more heavily on line managers to communicate and use the tools of the compensation discipline. In fact, the importance of line management's contribution to the *design* of the compensation program will increase in the future.

- **Paying for contribution, not job.** Literature within the compensation discipline indicates that the size of an individual's paycheck in the future will be more dependent on contribution than job grade. Furthermore, more income will be placed "at risk," meaning it will vary based on performance.

When compensation professionals can identify the levels of base salary necessary to attract and retain the caliber of employees needed for their organizations, they can tie that portion of pay to creative reward systems that provide for additional earnings opportunities resulting from business successes. This is no small task, but it is necessary to improve productivity and control operating costs.

Those who will have the responsibility of leading and managing the compensation discipline in the future will find their jobs to be both challenging and rewarding. The compensation discipline will be more complex and less mechanical, and, most importantly, it will afford creative, business-oriented professionals a chance to impact the culture, performance and profitability of their businesses significantly.

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