



ALIGNING COMPENSATION STRATEGY

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In recent years, the necessity for organizations to control labor costs, while at the same time increasing productivity and enhancing quality and customer service, has never been more urgent. Although many companies have become acutely aware of this problem, few companies have yet to fully address this issue. The present competitive environment requires new strategies toward employee compensation, new management and employee practices, and new methods of educating employees to the shifting competitive environment that has brought about the necessity for these changes.

At the same time that companies are examining the method and basis for compensating employees, there has been a growth in the number of companies seeking to develop high performance, high commitment work systems. These systems, based upon expanded roles for employees, require that employees accept more responsibility and accountability. Other organizational initiatives, such as flatter organization structure; more fluid organization design; and faster-paced, quicker-response customer focus have driven sweeping changes. Often it has been difficult for compensation systems to keep pace and support these changes.

Additionally, employee compensation is a critical component to financial success. Careful attention must be placed on the development of reward systems that reflect the financial capability of the company as well as reinforce the new directions associated with contemporary organizational strategies. Compounding all of these problems are the recent dynamics of the labor market. In contrast to the period 1985-1995, when wages and salaries grew only modestly, the period 1996-1997 has been marked by an increasingly dynamic labor market in which wages and salaries are beginning to grow at a pace not seen in many years. The tightened labor market has meant that, for the first time in many years, greater attention must be given to the traditional role of compensation, i.e., attraction and retention.

Changing compensation systems is a difficult task for any organization. Employee and management perceptions of organizational compensation systems are typically well-formed. Concerns and skepticism over how they will be affected by any new system are natural. It is difficult for organizations to achieve compensation driven changes in behavior if their compensation plans have not been adequately communicated, employee understanding and trust established, and new expectations firmly "seated" and accepted. It goes without saying that communications, training, and execution are critical.

Compensation in the high performance organization needs to **reinforce** the directions set by the leadership. We *underscore* the word reinforce as efforts to make compensation too great a driver for change may lead to unintended consequences. That is, if the organization becomes too heavily compensation driven, the focus may be lost on the factors leading to successful high performance organization, and instead toward short term compensation goals.

Compensation philosophy is the set of values and beliefs that an organization has in regards to compensation decision-making. This often is combined with a set of guiding principles that further assist in compensation administration. Many firms report that they have no formal compensation philosophy and this would certainly be true of many we have worked with over the years. However, we would argue very strongly that the collection of decisions that the firm has made over a period of time constitutes a compensation set of beliefs and values — a compensation philosophy — regardless of whether or not the firm has actually committed those ideas to a formal document. Compensation strategy is used to guide the design of specific compensation decisions.

Differences in compensation philosophies are widespread. Thus, some organizations believe in the widespread use of incentive compensation, while others only apply incentive compensation to a very narrow group of employees who are believed to affect the bottom line. This represents a significant philosophical difference between the firms. Another illustration may be found in the examination of the behavior of firms who seek to apply compensation levels "at the

ALIGNING COMPENSATION STRATEGY

midpoint.” These firms differ philosophically from those firms that seek to pay at the top of the market, thus enabling them to attract the highest caliber employees that they can find. Business settings often explain these differences. Some firms are proportionally more generous to certain levels of exempt employees, while others believe in principles of achieving widespread equity across all employees. The openness with which compensation decisions are made, and the degree of stakeholder involvement in those decisions, is yet another example of philosophical differences that may exist between organization.

Needless to say, compensation is a key issue for the high performance organization, as the employee and management systems utilized by the organization must be reinforced through the rewards structure. Again, our experience is telling in avoiding making compensation unduly controversial, thus adversely affecting the very heart of the high performance system.

Our approach to compensation strategy is shown in the model presented below. It is important to approach compensation strategically by developing a philosophy toward compensation, along with a set of objectives. Three factors are employed: (1) business and operating inputs; (2) industry and labor market practices and trends; and (3) employee inputs and preferences.

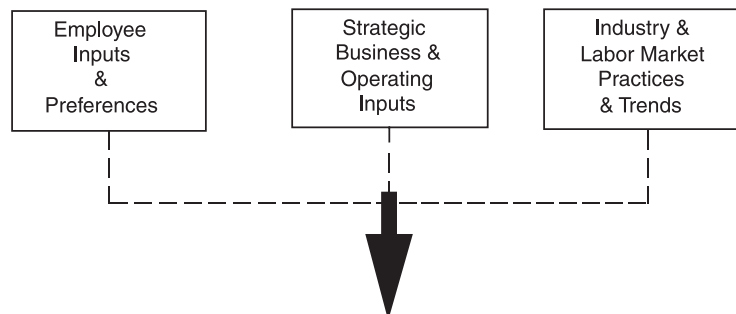
Once a philosophy and objectives are developed, the four elements of compensation can be determined. Base pay structures deliver to employees their wage or salary. Employees typically receive 90-100% of the cash compensation and two-thirds of their total compensation from their base pay.

Variable pay plans are organizational systems for sharing the economic benefits of improved productivity, cost reductions, quality, and overall business performance in the form of regular cash bonuses. Most variable pay plans incorporate existing, or develop enhanced, systems of employee involvement. To develop a variable pay plan system requires examination of existing management and compensation practices.

In most cases fringe benefit structures are set at a corporate level and are highly influenced by legal requirements. From the point of view of compensation strategy, fringes represent a substantial cost of total compensation and therefore must be considered as a strategic cost. Organizations derive little if any behavioral change from this portion of compensation. Fringes can influence attraction and retention.

Compensation administration includes a collection of activities required to sustain the effectiveness of a compensation strategy. Thus issues ranging from labor market surveying to performance management to skill certification and peer review come under this umbrella. Involving stakeholders in compensation administration can reinforce the values and beliefs underlying the compensation philosophy and strategy.

Assessment



Design

Compensation Philosophy and Objectives			
Based Upon Business, Operating, and Human Resource Requirements			
Base Pay Delivery	Organization Performance or Variable Pay, Nonmonetary & Other Monetary Rewards & Recognitions	Fringe Benefits	Compensation Administration

ALIGNING COMPENSATION STRATEGY

Below we provide a checklist of key compensation questions.

- ❑ ***Employee Inputs and Preferences***
 - Perceptions of external pay equity
 - Perceptions of internal pay equity
 - Pay delivery beliefs
 - Form (cash, gainsharing, benefits)
 - Method (individual, small group, large group)
 - Risk tolerance
 - Trust in management
- ❑ ***Business and Operating Inputs***
 - Operations and Manufacturing strategy
 - Sales development strategy
 - Percentage of compensation costs to total product/service costs
 - Percentage of compensation costs to controllable product/service cost
 - Existing markets/products
 - Potential markets/products
 - Anticipated volume
 - Reinforce/enhance work design
 - Maintain cultural change processes
 - Other operating issues
- ❑ ***Industry and Labor Market Practices and Trends***
 - Availability and quality of work force
 - Industry practices
 - Retention of work force
 - Retention of key contributors
 - Wage/salary levels and movement
 - Wage/salary delivery charges
- ❑ ***Compensation Philosophy and Objectives***
 - How much emphasis should be placed on rewards to drive organization
 - What issues are to be driven by compensation as opposed to management practices
 - Market definition (exempt and non-exempt)
 - Method of delivery
 - Targeted position in labor market
 - Targeted position in product market
 - Relationship within total company
 - Relationship to selection and retention
 - Portion of pay guaranteed and at risk
 - Percentage of workforce bonus eligible
- ❑ ***Base Pay Delivery***
 - Method of delivery — Job-based vs. individual-based
 - Number of levels
 - Structure of levels
 - Pricing strategies
 - Adjustment method
 - Weighting of individual performance
- ❑ ***Organization Performance or Variable Pay***
 - Role in total compensation strategy
 - Structure
 - Measures
 - Targets
 - Tolerance for pay at risk
 - Risk - reward ratios
 - Use of other monetary rewards
 - Use of non-monetary rewards
 - Individual performance recognition
- ❑ ***Fringe Benefits***
 - Usually determined at corporate level; limited scope at other levels
 - Tie to business and human resource objectives
 - Coverage
 - Cost
 - Communications (Purpose - Coverage - Value)
- ❑ ***Compensation Administration***
 - Stakeholder role in compensation administration
 - Performance management & evaluation
 - Overtime policy (exempt & non-exempt)
 - Shift differentials
 - Attendance policy
 - Role of seniority

Conclusion

Compensation decisions should be fully integrated into the organization's business and operations strategy, through its compensation philosophy. The design of compensation systems should be subsequent to, and not precede, this key analysis and decision point. For the high performance firm, an appropriate level of employee involvement can further reinforce the organization's general beliefs and values.