Compensation Plan Outline:
Philosophies and Objectives

OVERVIEW

Effective compensation design begins with a carefully deliberated compensation policy. Generally, companies determine a statement of compensation philosophy—a broad statement of the company's attitude toward employee compensation. This statement typically contains no specifics on how employee compensation will be paid but instead provides guidance for formulating the compensation plan.

After a compensation philosophy is set, companies can determine compensation objectives that state specifically what they want to accomplish with their compensation program.

This chapter provides information on setting compensation philosophy and objectives. Other chapters in this section provide more detailed information on specific compensation program components.

GENERAL PRINCIPLES

In General

The design of an effective compensation program begins with an analysis of the organization's philosophy—or value system. As they relate to compensation, these values stem from the age of the organization (entrepreneurial or mature); its industry (for example, high-tech, service, or manufacturing); and the company's ability to pay competitively.

This analysis should be repeated every two to five years, with the timing dependent on the organization's age, external forces affecting its industry, and its financial success. Building on this foundation, an employer can formulate its policies with clearly stated objectives. By developing a pay philosophy and defining objectives, an employer more easily can develop a sound compensation program and implement effective administrative procedures.

A company's compensation policy generally comprises four parts:

- ***philosophy statement***—a broad statement of the company's attitude toward employee compensation;
- ***objectives***—specific statements of what the compensation program will accomplish;
- ***program components***—a listing of particular compensation programs—for example, job analysis, performance appraisal, and incentive pay programs; and
- ***procedures***—specific statements of how to administer program components.

Compensation System Constraints

Organizations are faced with a number of constraints that affect their ability to accomplish the objectives of their compensation system:

- ***Company's ability to pay***—A company's ability often is linked to the company's age. Mature companies in stable industries usually can afford to pay employees a competitive salary, while entrepreneurial companies with fewer resources might have to pay a less competitive salary with a variable pay component based on revenues.

- ***Legal constraints***—Much of a company's compensation policy determination is driven by legal constraints. For example, employers are required by federal law to pay certain types of employees overtime pay at a rate of one-and-a-half times their regular rate for hours worked in excess of 40 in a week.
- ***Collective bargaining***—Unionized companies have to bargain over changes to pay plans affecting organized workers, even when making only minor changes. In addition, pay increases in unionized organizations often are dictated more by seniority than by performance.
- ***External labor market***—A company's pay plan may be constrained by its outside market for labor. Companies in tight labor markets often have to pay more to attract and retain qualified employees.

Compensation Committee

Most firms administer their compensation program through a variety of committees. The committee with responsibility for setting compensation policy usually is called the compensation committee and typically is composed of high-level managers. In some cases, the committee includes members of the board of directors and is responsible for determining top management compensation.

The committee ensures that compensation programs are altered to reflect changes in the firm's business strategy and financial status, and might have responsibility for reviewing actual pay program procedures and decisions to ensure that they conform to the firm's compensation policy.

Other committees for compensation administration might include a salary administration committee—with responsibilities for reviewing and evaluating merit pay plans and other pay increase plans—and a job evaluation committee—with responsibilities for evaluating the internal worth of jobs in the organization.

Communicating Compensation Policies

Communication of compensation philosophy, objectives, and plans is one of the most important areas of compensation administration, yet one that often is ignored.

Formal communication to employees about the compensation policy should both introduce the company's program in general terms and outline specific policies, such as:

- how wage levels are determined;
- salary ranges by job title;
- the minimum, median, and maximum for each pay grade and how the structure was developed; and
- how pay increases are determined and how often they are provided.

To be effective and uniformly applied, policies on compensation must be understood by all employees. Policies should be written and distributed with appropriate explanations to all supervisory personnel within the company. Subordinate personnel also should be acquainted with the company's policies. This can be done by providing a wage and salary manual or an employee handbook to employees.

Employers must be concerned about employee privacy, and therefore, should not reveal individual employee pay rates. General information about the pay system should be all that is communicated to employees. (For further information, see *Communicating Pay and Benefits Information to Employees*.)

COMPENSATION PHILOSOPHY AND OBJECTIVES

Compensation Philosophy Defined

A statement of compensation philosophy explains an employer's attitudes toward compensation and provides the guiding principles on which a compensation program are based.

When setting a compensation philosophy, the company should address four major—and often conflicting—criteria for determining pay:

- ***internal equity***—pay should reflect the relative value of each job to the organization;
- ***external equity***—pay rates should be correlated to the prevailing market rates; and
- ***individual equity***—each individual should be paid according to individual merit; and
- ***job evaluation***—pay ties to relative value of each within the organization's job hierarchy.

Internal Equity

Employees often compare their pay to the pay received by other employees in the organization. Internal equity comparisons are made among people on different jobs. Jobs requiring higher skill levels or more responsibility are perceived as more valuable than jobs requiring lower skill levels or less responsibility. For example, it would be perceived as inequitable to pay a computer systems operator less than the data entry clerk.

In determining internal equity, firms must rate all jobs in the organization according to each job's relative value to the organization. Usually, a process called job evaluation is used to establish internal equity in a firm. Jobs are valued based upon compensable factors.

The most common compensable factors are:
- responsibility,
- skill required,
- effort required, and
- physical working conditions.

External Equity

External equity is achieved when employees believe that their compensation is approximately equal to what they would receive if they worked in a similar job at another company. Employees tend to make these external equity comparisons within their own geographic area. For example, an accounting clerk in a rural area would not expect to be paid at the same rate as an accounting clerk in an urban area.

To ensure that a pay program is externally equitable employers must compare their wages to those of other area employers by analyzing wage and salary survey data.

Individual Equity

Employees also compare their compensation with the compensation of others in the same job. The jobs are of equal value, but employees are comparing their performance on the job or their seniority in the position. If employees feel they are inequitably treated—for instance, they are paid the same as a co-worker, but feel they are working harder—they will try a number of strategies to make their situation more equitable.

In response to a perceived inequity, an employee likely will ask for a raise, reduce his or her performance level, or look for work elsewhere.

Job Evaluation

Classification of each job in a consistent manner, reflecting actual job duties, results in the determination of the relative internal value of the job. Creating a solid job hierarchy, along with the assessment of internal and external equity, provides the foundation upon which fair pay practices can be established and maintained.

Formulating Compensation Objectives

The main goal of any compensation system is to influence individuals to make decisions that match the organization's needs.

Objectives commonly included in a company's compensation policy are:

• ***Recruitment***—Many factors influence an individual's decision to accept a position with a particular organization; however, economic factors generally figure prominently. Employers must determine whether their average pay levels will be equal to, higher, or lower than what the market pays.

• ***Retention***—Just as with motivating an individual to join an organization, motivating an individual to remain with the company is influenced by a complex set of variables. A worker who believes his or her pay is fair with regard to both the pay other employees in the company receive and the pay employees outside of the company receive will be more inclined to stay.

An employer also can influence an employee's decision to stay by increasing the costs associated with leaving the organization. One way to do this is by providing benefits—such as, vacation and pension—that are tied to length of service.

• ***Motivating performance***—Base compensation is provided to encourage employees to perform at an acceptable level, but most companies want their employees to perform beyond those minimum acceptable levels. Rewards in the form of extra compensation tied to specific goals or performance thresholds can provide an incentive for employees to perform at higher levels.

- Employers Group
    - A leading source for intelligent business, HR solutions, and employer advocacy, helping thousands of employers across the country – and around the world.
    - Membership: Employers Group serves as a member-based organization comprised of small to large businesses (10,000 + employees) representing multiple industries from manufacturing, professional services, healthcare and government.

- Compensation Solutions
    - At Employers Group, our consultants understand your needs. Our extensive HR background lets us tailor a program that goes above and beyond to meet your compensation and assessment needs.
    - Our resources and data give us the full knowledge to give you a competitive compensation plan to compete with today's labor market.
    - Our Compensation Solutions Include:

Compensation Services	**Job Classification Services**	**Services May Include**
○ Comparative Market Pricing and Analysis ○ Wage & Salary Administration Policy ○ Incentive Plan Design and Alternative Pay Programs ○ Executive Compensation Review ○ Performance Management	○ Job Analysis and Evaluation Programs ○ Job Descriptions ○ FLSA Exemption Review ("exempt" vs. "nonexempt") ○ Salary Grades	○ Documentation and recommendations for compensation policies ○ Implementation, including employee & management training ○ Strategic planning on compensation issues ○ Compensation philosophy development ○ Online solutions

Learn More: www.egsurveys.net/compensation-solutions/

- Juan P. Garcia – Organizational Research Services Director
    - Direct Employers Group's Total Rewards consulting practice
    - Responsible for advancing practices and findings around a total rewards model
    - Oversee EG's organizational assessment services, including employee opinion surveys, opinion polls, and custom surveys
    - Over 20 years of practical experience in compensation, research, and consulting

Juan P. Garcia
Organizational Research Services Director
Employers Group
400 Continental Blvd., Suite 300
El Segundo, CA 90245
O - 213-765-3969
jgarcia@employersgroup.com