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Linking Compensation Policies and Programs to Organizational Effectiveness



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There is little agreement on which pay philosophies are best in any given situation. With the exception of executive compensation, few empirical studies attempt to link compensation policies and programs to organizational effectiveness. Lack of empirical evidence, however, has not prevented compensation managers, academicians and consultants from prescribing a variety of policies and programs aimed at providing organizations with a competitive advantage. Since labor represents a major cost of operating a business, it would be in managers' best interests to learn which pay policies and programs are most prevalent in successful organizations.

Consequently, recent research tried to determine which base pay compensation programs are most commonly used in organizations today and if a relationship exists between compensation programs and organizational effectiveness.

Research Methods

Identifying the Research Population

The goal of the first phase of the study was to identify the pay policies and practices organizations are using today by reviewing literature and interviewing academicians, consultants and practitioners. The research team

drew heavily upon its more than 80 years of combined experience in the compensation field. Differences in terminology and program definitions used in the compensation field created a significant challenge to the research. To meet this challenge, the team tried to find the most common or universally used terminology and provide definitions for policies or programs to minimize confusion for respondents.

The team also recognized that there are variations in pay policies and programs across different organizational levels and occupations within the same organization. For example, exempt and nonexempt employees within the United States often are paid very differently. Consequently, research focused on managerial and professional employees since most organizations tend to have a uniform set of policies and practices for this group. The senior executive team was excluded from the study because their pay policies and practices often are unique. Furthermore, compensation managers would have substantial knowledge of the policies and programs for professional and managerial employees, especially since they are probably included in this group for pay purposes. Finally, this employee group tends to have a significant impact on total organizational performance, making this a critical group to understand in terms of pay policies and programs and organizational effectiveness.

Developing the Survey Instrument

In Phase 2, the team constructed a data collection instrument with statements and response categories that would generate a set of standardized responses so the data could be quantitatively analyzed. To enhance the richness of the findings, open-ended items were included to ensure that non-standardized responses were captured. During Phase 2, there were three cycles of pilot tests with compensation managers, consultants and academicians before the survey instrument was finalized.

The final version of the survey instrument asked participants to describe and evaluate their managerial and professional pay policies and programs as they related to:

- ▶ Compensation philosophy and goals
- ▶ Methods of valuing work
- ▶ Base salary structure and design
- ▶ Pay administration and communication.

The study did not examine incentive pay programs because a lengthened survey might have discouraged compensation managers from responding. A second study is in progress that will examine the relationship between incentive pay plans and organizational effectiveness.

Defining 'Successful'

Three measures determined the effectiveness of the pay policies and programs. First, the team compared the pay policies and programs between companies that received *Fortune* magazine's 2002 "America's Most Admired Company" designation for their industry sector and those that did not receive that designation. *Fortune's* "Most Admired Companies" is a highly regarded annual survey of corporate reputations, conducted by Hay Group, of more than 10,000 executives, directors and analysts. The survey invites them to rate companies, overall and within industry groupings, on criteria ranging from financial soundness and use of corporate assets to quality of management and quality of products and services.

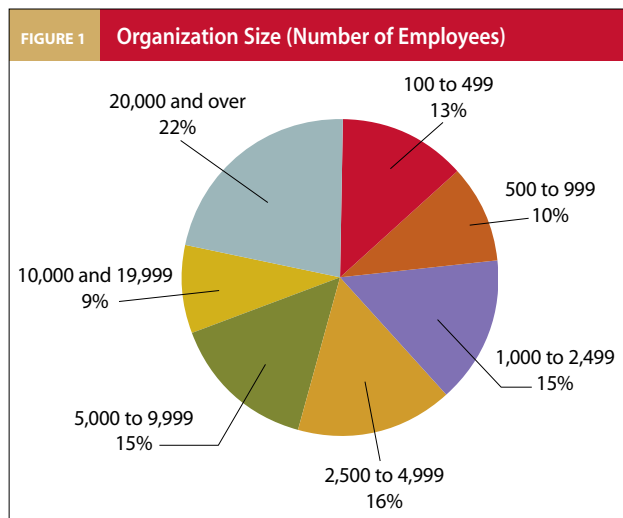
Second, the team collected 2002 total shareholder return (TSR) information for the publicly traded companies that responded to this survey. TSR is defined as the monthly percentage growth in stock price and dividends paid over the five-year period. The team divided the TSR data into quartiles and compared survey responses for the highest TSR quartile (i.e., the top 25 percent of companies) with data from companies in the lowest or bottom quartile of TSR (i.e., the lowest 25 percent of the companies).

Finally, survey respondents were asked to make a personal assessment of the effectiveness of their compensation policies and practices. Although this measure may be subjective, a compensation manager's perception of the degree of program effectiveness is a reliable indicator of success.

Response Rate

More than 9,000 WorldatWork members were invited to complete the survey. The membership sample targeted the highest-level compensation manager for each company. The survey was posted on the WorldatWork Web site for two weeks prior to the December 2002 holiday season. An e-mail communication was sent to each compensation manager from the sample requesting that the selected compensation managers access the Web site and complete the survey. There were 1,226 responses — a 12 percent response rate. Typical response rates are usually well below 10 percent. Over 99 percent of respondents completed the entire survey and were included in the analysis. Figures 1, 2 and 3 show how the sample represented virtually all organization sizes and industries.

The analyses reported here are descriptive statistics and t-tests comparing responses between “Most Admired” and other companies, and comparing



companies with the highest TSR (i.e., top quartile) and those with the lowest TSR (i.e., bottom quartile).

Findings are examined in three sections:

- ▶ Pay communication and employee understanding of the pay programs
- ▶ Direct compensation policies and practices
- ▶ Methods companies used to value work.

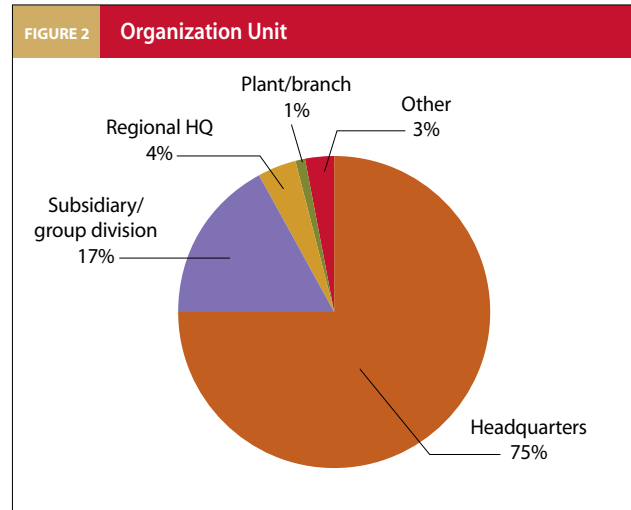


FIGURE 3 Industry

Industry	Number of Respondents	Percent (may not add to 100 due to rounding)
Manufacturing	225	19%
Health Care	144	12%
High-tech	18	10%
Finance/Banking	106	9%
Wholesale/Retail Trade	82	7%
Insurance	69	6%
Business Services	46	4%
Utilities	40	3%
Communications	40	3%
Service - Nonprofit	34	3%
Transportation	28	2%
Oil/Gas/Natural Resources	26	2%
Construction/Real Estate	19	2%
Government	16	1%
Education Services	15	1%
Publishing/Newspaper	11	1%
Other	156	13%

Pay Communication and Employee Understanding

Limited information is communicated about pay programs to managerial and professional employees. When asked how much information was shared with employees about their pay, respondents indicated that:

- ▶ 23 percent provided minimal information
- ▶ 59 percent provided information regarding the design of the pay program
- ▶ 7 percent provided the base salary for the employee's pay grade
- ▶ 23 percent provided base salary ranges for all pay grades or jobs
- ▶ 3 percent provided actual pay levels for all employees.

Organizations used a variety of channels to communicate the pay program, with a heavy reliance on communications through management, including:

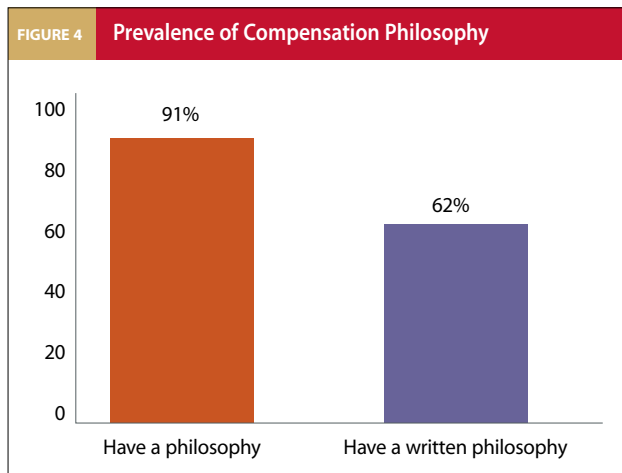
- ▶ 86 percent communicate via individual discussions with supervisor
- ▶ 54 percent utilize individual discussions with the HR or compensation department
- ▶ 41 percent communicate via e-mails and memos
- ▶ 34 percent communicate via employee meetings
- ▶ 31 percent posted information on the company Web site
- ▶ 2 percent never communicate.

The frequency of pay communication is low, with 52 percent of the respondents indicating that they only communicate with employees once a year, 35 percent two or three times a year and 10 percent four to six times a year. There were no substantial differences in how employers communicate to employees across different levels of TSR and companies that either held or did not hold "Most Admired" designations.

More than two-thirds (68 percent) of respondents evaluated their pay communications to be not effective or marginally effective. Interestingly, companies identified as "Most Admired" or those in the top quartile of total shareholder return (TSR) did not

evaluate their communications any more positively than the companies that were rated less effective. However, a more in-depth examination of how pay philosophy information is communicated reveals differences between effective and less effective companies.

Ninety-one percent of respondents indicated that their company had a compensation philosophy. However, only 62 percent of these compensation managers said their philosophy was documented. Articulating the pay philosophy in writing was a distinguishing characteristic of "Most Admired" companies and those companies with the highest TSR. (See Figure 4.) A written philosophy indicates senior management understands and is committed to aligning their business strategy with pay, suggesting that alignment can have a positive impact on organization effectiveness. A documented philosophy also may be interpreted as evidence that management is attempting to communicate their business and compensation strategies to employees. If a written compensation policy facilitates communication of the business strategy, employees may respond to this message by working more effectively. As might be expected, survey results indicate that employees are more likely to understand their company's pay philosophy when it is documented, compared to employees in companies that do not have a documented philosophy.



Base Pay

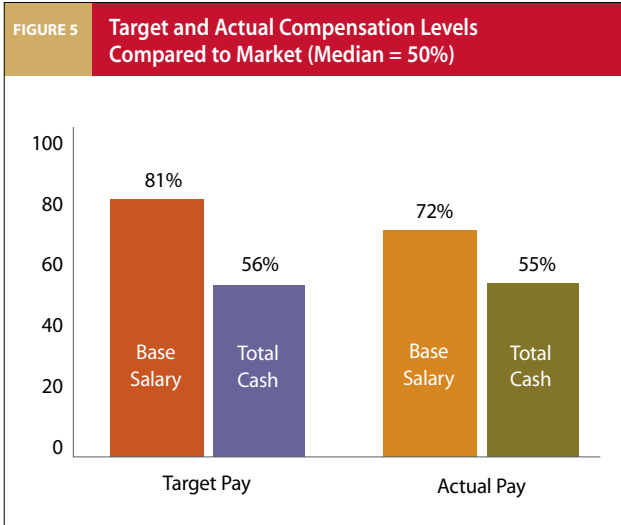
Compensation managers overwhelmingly reported that base salaries and total cash were positioned at the middle of the market. More than 80 percent of respondents said their goal for base pay for managerial and professional employees was the 40th and 60th percentile; and, in fact, 72 percent believed that their actual pay levels were at or near median. (See Figure 5.) Although statistically it is impossible for everyone to be median, compensation managers may either be targeting different labor markets or considering such a large variety of jobs that they covered most of the overall pay distribution.

Most pay ranges for managers and professional employees were less than 70 percent wide. There was no discernible difference in range width between companies in the top quartile of TSR and those companies not providing that level of return. Unlike what the compensation literature implies, survey data indicate that few companies have implemented “broad banding” for their professional and managerial employees.

When asked how base-salary increases were determined for managerial and professional employees:

- ▶ 68 percent said that individual performance was compared to job standards
- ▶ 50 percent compared performance to pre-established objectives or MBOs
- ▶ 50 percent used the market value of the position
- ▶ 22 percent judged performance on skill or competency acquisition
- ▶ 9 percent based increases on years of service and
- ▶ 8 percent gave general increases to everyone.

These data indicate that most pay increases are based on individual merit, such as performance, compared to job standards, competency acquisition or MBOs. Less than 10 percent of respondents indicated that their organizations used years of service or general increases. However, 50 percent said they would give pay



increases based on the job value in the market place. This represents a major change in how pay increase budgets are used today compared to even five years ago. This change may be because merit budgets have been modest in recent years and increases have not been substantial enough to move employees with good performance records toward the top of the range. Nearly one-third (33 percent) of the respondents indicated that their performance rating system does not, at least directly, drive pay increases. This is a significant minority given the current emphasis on pay for performance.

Variation in pay increases between high and average performers was surprisingly narrow. Almost one-third (32 percent) of respondents said that pay increases were more than double the increases given to average employees. Although the idea that top employees should be highly rewarded, even during economically difficult times, has received considerable press, this does not seem to be occurring in most organizations.

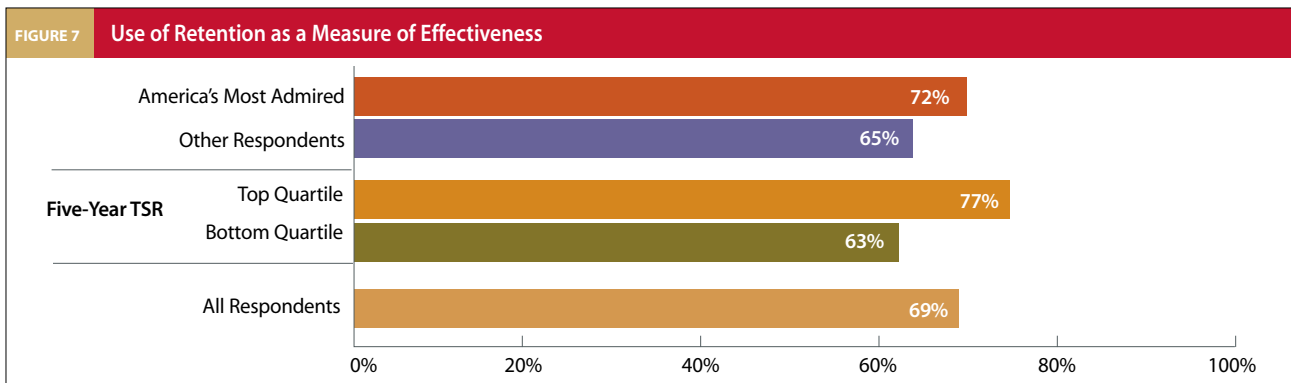
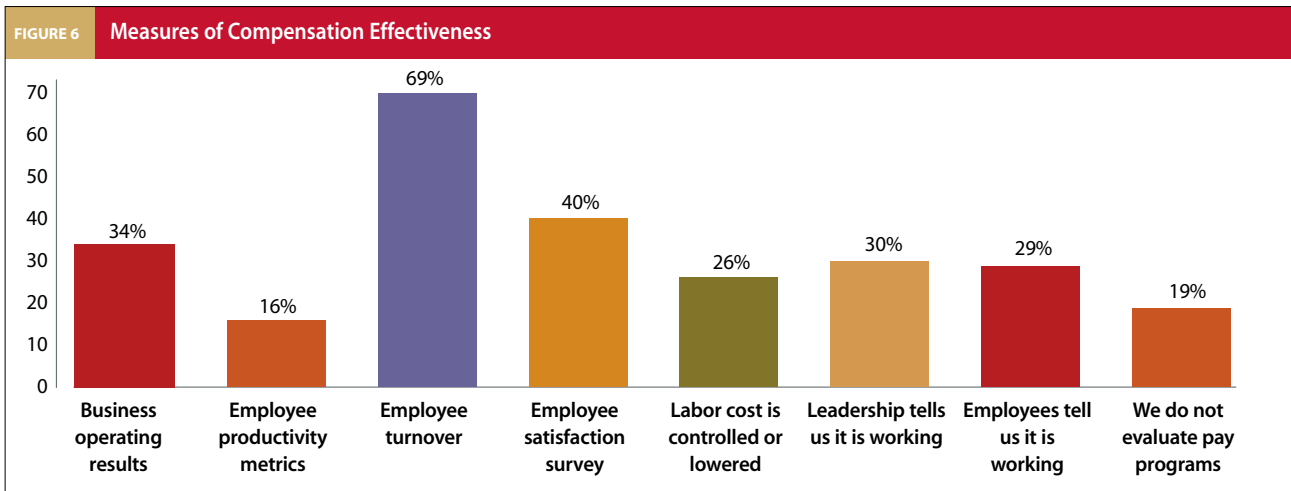
Survey findings indicated that base pay structures are adjusted annually (74 percent), market pricing or pay surveys are conducted annually (60 percent) and most salary ranges are less than 70 percent (72 percent).

When asked which performance measures senior management use to judge pay program effectiveness, more than two-thirds (69 percent) said “employee turnover or retention.” (See Figure 6.) The second most common evaluation criterion was through employee satisfaction surveys (40 percent). Business operating results and employee productivity were likely not reported as being used as frequently as evaluation criteria since the study focused on base pay and not incentive pay. Interestingly, companies designated as “Most Admired” and top TSR were more likely to use employee retention as primary criterion for evaluating the effectiveness of their pay systems than other surveyed companies. (See Figure 7.) This is a clear indicator of how successful organizations view base pay.

Valuing Work

A substantial majority (between 82 percent and 96 percent) of compensation managers indicated that they used some form of job evaluation, and 98 percent of organizations market priced their jobs (i.e., conducted pay surveys). In fact, the vast majority of organizations do both — up to 93 percent of organizations evaluate and market price jobs. This finding demonstrates that some of the HR discussions regarding the debate on the appropriateness between job evaluation and market pricing are essentially moot, at least for professional and managerial employees. Thus, it seems that most compensation professionals recognize that both job evaluation and market pricing are critical and engage in both processes.

There are no clear patterns, however, in how organizations resolve conflicts between market pricing and



job evaluation information. When there are conflicts between the job evaluation and market data, 38 percent of compensation managers give priority to job evaluation and the same percentage give priority to market pricing. Eleven percent of the respondents combine the two approaches, relying on job evaluation to set the job grade or level and market pricing to set pay levels.

Ninety-seven percent of survey respondents reported that their organization has some form of job documentation, but only 32 percent said that they had up-to-date job descriptions on almost all (over 90 percent) of their jobs. Thirty-four percent reported that most job descriptions are *not* up-to-date. This is a serious problem not only for organizations that use job evaluation, but also for those that use market pricing, since the accuracy of these tools depends to a degree on having an up-to-date understanding of the work, which in many cases is obtained via job descriptions.

While there has been much talk of line management taking a stronger role in valuing work and making pay decisions, HR managers are primarily accountable for this process. In 60 percent of the surveyed companies, HR alone assigned jobs to grades. HR and line managers collaborated on the job evaluation process in only 28 percent of the surveyed companies. Successful companies were even more likely to have HR alone assign jobs to a salary grade. (See Figure 8.) In addition, 82 percent of organizations

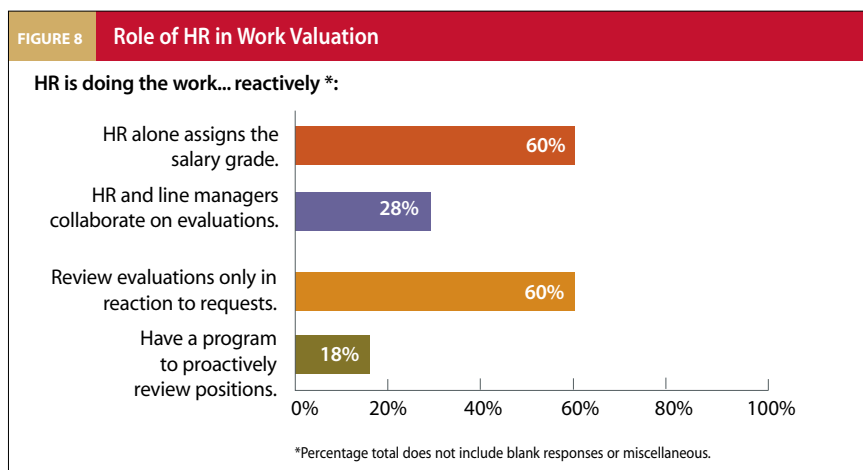
indicated that job grades are reviewed only in response to a request from managers or incumbents. Only 18 percent of organizations proactively review or audit job grades periodically.

Given the overall context created by out-of-date job descriptions, limited involvement of line management and reactive review of job grades, it was not

surprising to find that 41 percent of survey participants believe that at least 20 percent of their organization's jobs are placed in the wrong grades. There are serious cost implications for assigning jobs to the wrong grade. For example, if 20 percent of a company's positions are in an incorrect grade, and grades typically are 10 percent apart, then the company is misallocating 2 percent of its payroll. This is a significant cost since this error is more than one-half of most merit increases awarded this year.

If an incorrect grade assignment is to a higher grade, then the company is paying employees more than their stated policy or what the market demands. Likewise, if employees are placed improperly in a lower grade, then the company has the increased cost of replacing their employees who might pursue better paying jobs elsewhere as a result of not earning what the work is worth. This is particularly dangerous because the employees who typically leave are the "best and brightest" because they are more likely to find employment opportunities elsewhere.

Designing and administering systems that determine the value of work or the value of the employee doing the work is, perhaps, the compensation professional's primary accountability. The data collected from more than 1,200 respondents indicated that companies might be paying a substantial financial price for not investing the necessary organization resources into



valuing work. First, only 58 percent of compensation professionals who responded to the survey believed that 60 percent or more of their positions could be matched to the market. This combined with the observation that positions that cannot be matched to external compensation surveys are quite often positions that are designed uniquely within the organization as well as those that provide the organization with competitive advantage. What reason, other than competitive advantage and value creation, would cause companies to design jobs so differently from other organizations that they cannot be matched to the market? Therefore, it is quite likely that organizations that do not have

adequate market pricing information on these unique positions nor an adequate internal work valuing system are incurring risks of either overpaying these positions or increased probability of losing these critical employees if they are paid below where they should be.

The Perceived Effectiveness of Pay Programs

Compensation professionals were asked to evaluate the perceived effectiveness of various attributes of their compensation programs. These results, which are shown in Figure 9, reveal some interesting findings.

FIGURE 9 Effectiveness of Pay Practices as Evaluation by Respondents			
Job analysis and documentation processes		Market pricing processes	
Do not use	17%	Do not use	3%
Not effective	2%	Not Effective	1%
Marginally effective	21%	Marginally Effective	12%
Effective	51%	Effective	62%
Very	8%	Very	22%
Job evaluation or grading method		Merit pay (i.e., salary increases based on performance)	
Do not use	18%	Do not use	6%
Not effective	1%	Not effective	4%
Marginally effective	18%	Marginally effective	32%
Effective	53%	Effective	49%
Very	11%	Very	9%
Process for employees to appeal job grading or salary decisions		Individual performance appraisal	
Do not use	48%	Do not use	2%
Not effective	4%	Not effective	6%
Marginally effective	20%	Marginally effective	33%
Effective	26%	Effective	50%
Very	3%	Very	9%
Salary ranges		Alignment between organization and individual performance goals	
Do not use	9%	Do not use	7%
Not effective	2%	Not effective	11%
Marginally effective	14%	Marginally effective	38%
Effective	58%	Effective	38%
Very	18%	Very	7%
Note: Columns may not add up to 100% due to rounding.			

- ▶ More than half of compensation professionals responding to the survey believe their job analysis and documentation process and job evaluation processes are effective or very effective, at 59 percent and 64 percent, respectively.
- ▶ Market-pricing processes are deemed effective or highly effective by 84 percent of respondents.
- ▶ Individual performance appraisal is judged effective or very effective by 59 percent of responding compensation professionals.

Overall, compensation professionals judge their compensation programs to be effective or highly effective as they relate to managing internal equity (75 percent), managing external competitiveness (80 percent) and ability to attract and retain talent (81 percent). However, they judge their program's ability to motivate employees less positively (38 percent). The effectiveness of communicating the pay program is rated effective or highly effective by only 27 percent of respondents. The relatively higher effectiveness ratings on internal equity and external competitiveness management also may be attributed to the fact that the compensation department largely controls these programs. The relatively low effectiveness rating on the motivational value may be due to the fact that line managers within the organization need to work with the HR function to create an impact here — and this is challenging work for the organization.

Another potential cause for the perceived weak linkage between pay and motivation may rest with the finding that 68 percent of compensation professionals gave pay increases of less than two times to their high performers as compared to the average performers. A higher percentage of "Most Admired" companies reported rewarding top performers at two times or more than the average increase. There are clearly significant opportunities for HR to improve the quality of compensation through effective program implementation.

The attributes of pay policies and program design for professional and managerial employees have not changed substantially over time.


Future Directions

The information collected from this study offers insights and opportunities for creating higher impact pay systems. First, it's important to recognize that the attributes of pay policies and program design for professional and managerial employees have not changed substantially over time. There is a predominance of more traditional, time-tested compensation program designs than the literature and variety of compensation experts might lead one to believe. In fact, most organizations:

- ▶ Use both job evaluation and market pricing to place a value on their jobs
- ▶ Attempt to pay near the middle of the labor market
- ▶ Have pay ranges between 30 to 70 percent of midpoint
- ▶ Adjust salary ranges annually
- ▶ Make HR the dominant role in evaluating positions and assigning pay ranges
- ▶ Provide base salary increases based on individual performance
- ▶ Provide minimal pay communications to employees.

Research findings indicate that while the design of pay systems may indeed be "time tested," there is considerable room for improving the implementation of new pay policies and programs and enhancing the effectiveness of existing pay systems. Determining what

constitutes a successful pay practice is critical, because of the cost and motivation implications of pay systems that are either not designed or implemented effectively. The impact of pay policies and programs on employee behavior and motivation is significant and HR has a major role to play: First, by guaranteeing that scarce organizational financial resources are focused where they should be; and second, by making sure that the organization has the right alignment between the business strategy and pay programs. Finally, compensation professionals need to ensure that the pay programs are effectively administered and kept up-to-date.

This research has confirmed the linkage between pay policies and programs and organizational effectiveness. Consequently, compensation professionals need to help management understand how compensation decisions are going to affect company competitiveness. By clarifying how compensation impacts the organization, taking leadership on compensation issues, enterprising HR has a critical role in building a successful organization. 

Webnotes

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