

Repositioning Your Pay Programs for Recovery Six Steps for Conducting an Effective Compensation Audit

By Aria Glasgow, Vice President and Jim Hudner, Managing Director

While the current economic climate is still unsettled, most signs point to a slow, steady rebound from the “Great Recession.” Companies are beginning to hire again and are resuming or increasing spending on merit increases, incentive/bonus payouts and equity awards after a prolonged and painful focus on managing payroll cost. That makes this an opportune time for employers to take stock of whether they are getting the best return on one of their most significant expenditures.

While employers often conduct “annual check-ups” to assess whether pay levels are competitive with the market, there are also more complex issues that should be addressed periodically. This is particularly important given the pronounced changes to compensation practices over the last two plus years, and the unevenness with which they were applied depending on the industry, region, or employer. A more in-depth examination can ensure that compensation practices are properly aligned with market practice and the organization’s evolving business strategy for the recovery.

This article outlines a six-step process for performing an employee compensation plan audit, either independently or with help from an outside consultant. It includes guidance on how to gather key data; assess actual pay level and practices as compared to your company's compensation philosophy; evaluate the effectiveness of market comparisons; determine appropriateness of pay structures; and review employee communications.

Table 1: Data Needs

Before You Begin...

Among the essential data and information needed for a compensation audit:

- Recent business plans
- Organization charts
- Turnover rates by position, level, job family
- Open positions & time to fill vacancies
- Exit interview feedback
- Recent employee opinion surveys
- Compensation philosophy
- Compensation (salary, STI, LTI) plan descriptions
- Pay guidelines or pay-setting practices
- Salary structure/pay ranges
- Job evaluation tool(s)
- Job title structure and conventions
- Annual incentive targets
- LTI grant table
- Compensation communications / handbooks
- Detailed annual market analysis
- Employee census (current and historical)

Step 1 - Does Compensation Support Your Organization's Current Business Strategy?

Some organizations will be able to address this issue by validating a well-defined compensation philosophy. Others will need to step back and conduct a more detailed assessment that includes input from leadership. There are multiple triggers for reassessing the organization's compensation philosophy against its business needs. These include a significant change in strategy such as re-branding, entering a new market, or introducing very different product/service offerings; major changes within the organization structure; plans for aggressive acquisitions; or a focus on new skills or competencies. In those circumstances, the philosophy should be re-examined to assess:

- Whether compensation practices should be centralized or tailored to other segments of the organization such as business unit, functions, geographic region
- The relative emphasis on team vs. individual accountability and performance
- Policies to evaluate and monitor behaviors and actions that may drive compensation-related risks
- The extent of management flexibility in pay decisions
- The integration of compensation with broader total rewards strategy (e.g., benefits, work environment, etc.)

Step 2 - What Do Participants Think of the Compensation Plan?

Even a compensation program that looks great on paper won't be effective unless line managers believe it supports their efforts to attract, reward and retain needed talent. When our clients have initiated group or individual meetings on this issue, they find most managers are very forthcoming about what they think works and doesn't work in the current compensation plan. Among the issues commonly revealed by this often-overlooked step in the compensation process:

- Managers were misinterpreting some pay policies
- Managers were unaware of some programs (e.g., recognition)
- Managers were not aware of and therefore lacked confidence in market pay positioning

These meetings can lead to constructive input on compensation programs that leads to better communications around pay and more engaged and supportive managers. In addition, if your organization regularly conducts employee opinion surveys, it may be helpful to assess any trends or red flags with respect to employees' perceptions on compensation.

Step 3 - How Does Compensation Link to the Market?

How your organization compares itself to the marketplace is another critical element in attracting and retaining top employees. There is rarely a single data source that exactly fits an organization's needs, so that even under stable conditions compensation professionals may spend hours analyzing and participating in multiple compensation surveys. We find that many companies end up using the same matches and same surveys for years. However, the changing economic environment makes it more important than ever to assess whether your compensation surveys reflect your labor

market and continue to provide the most relevant data for your needs. A detailed re-assessment of job matches, sampling, job leveling, survey weighting, cross-survey consistency, data cuts and specific data compiled can determine whether there is still a sound link to market practices.

As you monitor changes in the competitive marketplace in the near future, there are some things that merit special attention in the recovering economy:

- *Salary increase budgets and movements* – Companies may be cautious with advancing fixed costs over the next few years
- *Annual bonuses and incentives* – Organizations are likely to broaden the use of variable pay to manage fixed costs and reward performance
- *Equity* – We expect continued declines in equity participation at lower levels due to cost concerns and such employees’ limited line-of-sight
- *Competitive pay strategies* – Emerging targeted “hot skill” areas will require creative strategies to compete for limited talent

Step 4 - Is Your Compensation Infrastructure Effective?

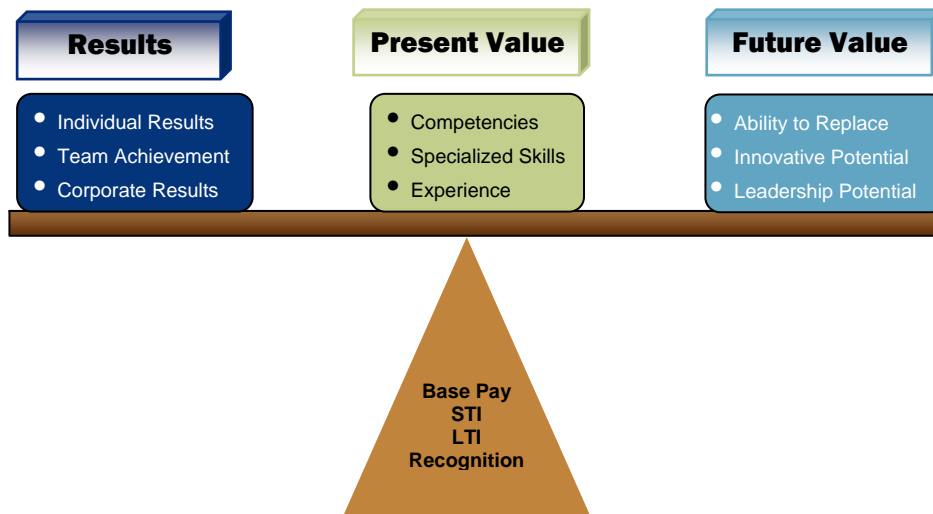
The compensation infrastructure provides the parameters for delivering pay based on the organization’s particular size, complexity, maturity, industry and compensation philosophy. As a company grows and changes over time, the infrastructure will need to be tweaked or even significantly changed. That calls for an assessment of program objectives versus actual practice, as well as compared to market practice. This review should include the following:

| Compensation Infrastructure Component | Key Considerations |
|---------------------------------------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| Job Titles | <ul style="list-style-type: none"> • Use of internal/external titles • Criteria for managerial titles • Relationship to market practice |
| Job Descriptions | <ul style="list-style-type: none"> • Degree of specificity (role-based, job-based, person-based) • Consistency across organization • Use of descriptions (responsibilities, appraisal) |
| Job / Career Levels | <ul style="list-style-type: none"> • Number of levels/relationship to market practice • Basis for progression/distribution of employee population • Description of levels/relationship to market practice |
| Pay Ranges | <ul style="list-style-type: none"> • Alignment to market pay • Linkage to other programs (e.g., STI, LTI, Perks) • Recognition of geographic wage variations |
| Job Evaluation | <ul style="list-style-type: none"> • Adequacy of tools/processes used • Consistency in application/validation of results • Assessment of “grade creep” |
| Short-term incentives | <ul style="list-style-type: none"> • Eligibility and participation compared to market • Basis for defining award opportunities/link to market • Integrity of performance measures/targets (historical payouts) |
| Long-term incentives | <ul style="list-style-type: none"> • Eligibility and participation compared to market • Basis for defining award opportunities/link to market • Perceived/real value of equity awards |

Step 5 - How Do Your Pay Delivery Practices Stack Up?

The proverbial rubber hits the road when compensation is paid out. An organization's approach to pay delivery should reflect its business, culture, values and people strategy, striking the appropriate balance among various pay delivery vehicles and desired messages. As organizations gear up for the recovery, they should be keeping a particular eye on eligibility and opportunity levels for annual incentive/bonus plans. Given the continued emphasis on cost and maintaining a pay-for-performance linkage, we expect that many organizations will increase eligibility and awards while closely managing salaries. Additional issues to examine include the gap between top and bottom performers, whether pay is sufficiently differentiated between performance levels, and the type of performance being emphasized. For example, if an organization that is losing market share emphasizes team-based rewards; it may need to shift its focus more to individual results to reinforce employees' personal accountability.

Striking the Right Balance Among Approaches to Pay Delivery



Step 6 - How is Your Plan Communicated?

The interviews conducted at the beginning of the compensation audit should provide a good sense of how well your policies are understood by managers. Reviewing employee opinion surveys can be helpful in assessing employee's understanding of the compensation program, highlighting any gaps or alarming trends. In addition, plan materials should be reviewed to verify they are consistent with current company policies and programs, as well as market practices. Consideration should be given to the vehicles, audiences and frequency with which pay programs are communicated. Finally, with the constant changes / improvements in communications methods and the different preferences among employees on how information is received, this provides a great opportunity to ensure there are varied means of communicating the same information. For instance, some may learn best from a detailed Policy and Procedure Handbook, while others may prefer shorter FAQs or presentation style learning materials.

After the Audit is Completed

A thorough compensation audit includes an outline of recommendations and alternatives that are categorized by priority and include estimated timeframes and projected costs. Done properly, the audit will provide companies with an effective roadmap to update compensation programs so they remain relevant and effective even in a changing economy. That said, with the pace of change in our world today, such audits ideally should be conducted every three to five years.

About the Authors

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For more than 20 years, PM&P has served as a trusted independent advisor to Boards and their senior management in the areas of compensation governance, strategy and program design. The firm provides comprehensive solutions to complex compensation challenges through the development of programs that align rewards with business goals to create long-term value for all stakeholders: shareholders, executives and employees. The firm maintains offices in New York, Atlanta, Boston, Charlotte, Chicago, Houston, Los Angeles and San Jose.



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