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Compensation Philosophy

This is the first in a series of articles on the elements of an effective compensation program. The series of articles will highlight each of the various parts of a typical compensation program. This first article will highlight the best practices a company uses when developing a compensation philosophy.

When developing a compensation program one must first work with top management to develop a philosophy for the company. A compensation philosophy is a set of principals that guide the design, implementation and administration of the compensation plan. It should drive the strategy that aligns an organization's compensation program with the organization's mission, goals and business objectives.

What is addressed in the compensation philosophy will depend upon how broadly the term "compensation" is defined. Regardless of the definition of compensation one uses, it should at a minimum promote an integrated view of all rewards provided by the company. If one wants it to be a "best practice" philosophy, then it should not only include the traditional elements, but also include career opportunities, learning and development, work challenges and describe a supportive culture.

Below are the elements of a "best practice" compensation philosophy that will lead to an effective program.

- **The philosophy will either support the organization's mission and strategy or take a lead role in changing it.**
  There are always at least two pieces to the basic pay that an employee receives. First is pay for membership in the organization. It takes some amount of money to get an employee to join a company. Second, changes in the basic pay should be a result of the employee's performance on the job. This means that the compensation program must directly link to the performance of the employee, typically through a performance appraisal which include a set of objectives tied to the organization's mission and strategy. The employee must know that there is a relationship between the two and must understand the process or systems by which they are paid.

  An example of a compensation program that takes a lead role in the business strategy is the "Dot Com" era a few years ago when most of their pay philosophy was to pay low base salaries to accommodate low cash flow, and to award large stock options to tie the employee's interest to stockholder interest.

- **Compatible with the organization's culture and needs**
  This may sound obvious, but it is surprising to see companies trying new compensation programs that are contrary to their preferred culture. For example, a company with traditional management approach that tries to implement skill-based pay. The culture for skill-based pay needs to be one in which "management and labor are willing to cooperate and where the job structure allows the employees the

freedom and support to grow without limitation of traditional job descriptions. Employees need to be empowered to make decisions, to join with their peers in searching out and correcting quality and other productivity problems, and to exercise choices about work, pay and job satisfaction."[1]

- **Cost effective and externally competitive**
  The company philosophy must address the market relationship it will seek with its pay practice. If the company pays too high, it runs the risk of pricing itself out of the market in order to maintain the high wages. If it pays too low, it runs the risk of not being able to attract and retain the level of employee that it takes to carry out its mission and strategy. So there must be a balance, it must be competitive yet cost effective.
- **Share success with employees who help the organization succeed**
  Most companies across the U.S. have implemented variable pay plans over the last 20 years that pay off when the company does well and, if designed correctly pays little or none when the company does not do well. This slows the build up of fixed compensation cost and rewards the employee for positive achievements that also benefit the organization.
- **Integrated with other HR programs**
  The compensation program must support other human resources programs such as recruiting. If the recruiting effort is to hire the best employees in the labor market and the company builds a compensation program that has the intent of paying ten percent below the market, the incompatibility could result in failure for both programs.
- **Simple to communicate & relatively easy to administer**
  When building a compensation program we must follow the old "KISS" principle. Keep it simple, stupid. If it is so complex that no one outside the compensation department understands it, it will not receive the support necessary to make it successful. Make it as simple as possible, get employees involved in the design of the programs and they will help to keep it easy to understand and administer.

With this said, how does one go about developing a compensation philosophy that includes all of these elements? In Chapter Two of the Compensation Guide, Stephanie Y. Wilson lists a number of questions one must ask and get answers to in order to develop the philosophy.[2] Those questions are listed below:

- What business and organizational objectives should the compensation system support?
- How competitive should salaries be? Should they be in the 50th, 75th, 90th percentile?

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[1] Ghorpade, Jai & Edge, Jerry, Understanding Skill-Based Pay: An approach to Designing and Implementing an Effective Program, American Compensation Association, 1997, p3.

[2] Wilson, Stephanie Y., Compensation Guide, "Developing a Total Compensation Approach," Warren, Gorham, Lamont, 2004, p. 3-9 to 3-10.

- What is the competition for each job? Natinal, Regional, Local, Industry Specific
- Which jobs are individual contributors? Which jobs involve work in teams?
- How much compensation should be variable versus fixed for each job?
- How should benefits and perquisites fit into the total compensation philosophy?
- What tenured is the management staff? Has any reorganization taken place during the past two years? Has there been any turnover in the upper management group during the past two years?
- Is a sense of employee involvement important?
- Are alternative work arrangements required?
- Is there a need for any special practices, such as hazardous duty or personal hardship pay?

Human Resources and top management should work together to answer these questions. The answers will lead to the compensation philosophy for the company. Once the philosophy is developed, it should be communicated to employees to help them understand the guiding principles of the program.

In the next issue I will focus on the base pay portion of a good compensation program.

[1] Ghorpade, Jai & Edge, Jerry, Understanding Skill-Based Pay: An approach to Designing and Implementing an Effective Program, American Compensation Association, 1997, p3.

[2] Wilson, Stephanie Y., Compensation Guide, "Developing a Total Compensation Approach," Warren, Gorham, Lamont, 2004, p. 3-9 to 3-10.