
The Case for a Compensation Philosophy: Aligning Pay Dollars with Business Strategy and Direction

By Ann Bares

Are your pay dollars being well spent? Is your compensation program accomplishing what it should? How do you know?

For many organizations, these are difficult questions to answer. It may be that information on pay practices is not readily available, or not organized in a format that lends itself to examination and analysis. It may be that the information is available and organized, but no one has taken the time to give it the proper attention. One of the most common reasons, however, is that the senior managers facing these questions are not sure what to measure the pay program against. They haven't stopped to articulate their intent. They haven't taken the time to answer the basic question:

What do you want your pay program to accomplish?

Most organizations would never consider leasing a new building or purchasing a major piece of capital equipment without examining the expected return on investment. Is there a reason why the money spent on compensation should be handled with any less rigor? Given the fact that compensation accounts for the lion's share of costs in most businesses (for profit or not), it's important to treat that investment seriously and ensure that the funds being expended are accomplishing what they should.

A compensation philosophy is simply a statement that articulates the objectives and priorities for the compensation program. It represents the consensus of the organization's leadership with respect to what should be accomplished – and how – with the dollars spent on employee compensation.

A sound and comprehensive compensation philosophy, one which will guide the alignment of pay decisions with business direction, can be developed by considering the six key philosophy elements outlined below.

Overall compensation objectives. What do you want your compensation program to do? Try to drill down beyond the standard “attract, retain and motivate” to identify the critical three to five things your pay system must accomplish to support the organization's desired direction, strategy, values and culture. Is it *encouraging and rewarding cross-organizational collaboration*? *Directing all discretionary pay dollars to the top individual performers*? *Supporting learning and growth within current roles and responsibilities*? Be clear on the things that will drive your organization's success and establish pay objectives that will facilitate them.

Market positioning. This element has two parts. First, you must define your labor market for talent. Note that your labor market competitors may be, and often are, different than your business competitors. Ask the questions: *Where do we get our employees from? Where do we lose them to? Does this differ by employee group?* Consider industry or type of business as well as geographic location. It may be that your hourly plant workers come from a cross-section of industries right in town, while your labor pool for management is a few select organizations spread across the country.

When you've defined your labor market competitor(s), then you must address the second part of this philosophy element, which is how your organization wishes to pay relative to the competition. Do you wish to pay *at median (the “center” of market practices)*? *Above? Below?* *Should the answer be the same for all employees – or do certain key functions/positions require different treatment?*

Pay mix. Here we examine the components of your compensation program (i.e., base salary, incentives, etc.) and determine their relative role and proportion in the overall pay package. *What portion of compensation do you intend to deliver in the form of fixed base salary? Should some or all employees have some portion of their compensation “at risk” in the form of variable or incentive pay? Should the pay mix be the same for all employees, or should certain positions be treated differently?* It is common, for example, to find executive and management employees with more pay at risk than professional, technical or administrative support workers.

Reward focus. Consider the nature of the work performed, the desired culture and values of the organization, and the future direction of the business. *What types of effort and contribution should be the focal point of your pay practices? Individual? Group or team? Cross-organization?* Historically, many pay programs have focused almost exclusively on individual contributions. To what degree, if any, should your organization reward interaction and collaboration?

Nature of structure. *How should employees develop and grow within the organization? What should their careers look like? Should they involve a series of promotions up the hierarchical ladder? Cross-functional learning and movement? Increasing levels of competency and skill within current roles?* Your pay structure should reinforce – not get in the way of – the kind of mobility and development that will best support organizational success. For example, a traditional salary structure with many grades and relatively narrow salary ranges will support career movement based on frequent promotions, but may present a challenge to cross-functional learning and movement.

Administrative guidance. *Do supervisors and managers have the knowledge and understanding needed to make effective pay decisions? What level of guidance and prescription will be required to support their efforts? Is the organization willing to invest in the training and support necessary to allow supervisors and managers some flexibility and discretion in pay determination?* The answers to these questions will help you determine the kinds of administrative information and materials -- “tools” or “rules” – you will need to ensure that pay decisions are aligned with the intent spelled out in your compensation philosophy.

Your statement of compensation philosophy, then, is simply a document that reflects the organization’s agreement regarding the above elements and questions. Once developed, the compensation philosophy provides the statement of intent (what *should be*) against which current practices (what *actually is*) must measure up. Any gaps between intent and practice can then be identified and addressed.

Are your pay dollars well spent? Is your compensation program accomplishing what it should? With your compensation philosophy in hand, you are prepared to address these questions and maximize the return on your organization’s investment in employee pay. Without it, you risk a missed opportunity to put those dollars to work driving the organizational behaviors and efforts needed for success!

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