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The Fiscal Management of Compensation Programs

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for coordinating HR functions that were formerly disconnected. Total rewards is a bundling of several activities in a new way, and HR professionals must work together to realize the objective.

The specialist culture test underscores the importance of valuing and protecting new functions, such as work-life programs. A stand-alone corporate-level function provides ideal protection and visibility.

Designing a total rewards organization is an important and complex task. Fortunately, HR planners have a tool for handling the design process that ties structure to strategy and minimizes the chances for error. WJ

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The Fiscal Management of Compensation Programs

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Employee compensation is a major expenditure that can easily represent anywhere from 20 percent to 30 percent of revenues in manufacturing. In service industries it can reach 80 percent of revenues (Henderson 2006). High labor costs create real competitive challenges, such as those currently being experienced by United Airlines and General Motors, among others. Thus it is not surprising that the fiscal management of compensation programs is a key accountability criteria for senior executives in most organizations. However, few research studies have examined fiscal-compensation management practices and the effectiveness of these practices. Using the "Fiscal Management of Compensation Programs" survey conducted by WorldatWork, Hay Group and Loyola University, the authors analyze the design, execution and governance of compensation programs by focusing on several areas:

They identify the nature of control and influence that compensation (or human resources), operations and finance have over compensation program design, administration and control of expenditures within the organization.

- They examine the degree of centralization in the fiscal control of compensation programs (e.g., corporate level, business-unit level, line-manager level or employee level). Of particular interest is the degree of line-manager control and influence over exceptions to company policy vs. the authorization required by compensation or finance.
- They determine whether separate guidelines, practices and controls exist for different pay programs, including authorization of base salary increases, and variable pay eligibility and allocations.
- They evaluate the effectiveness (as reported by compensation managers) of the fiscal control methods used to manage compensation programs — specifically, the differences in fiscal compensation management practices between *Fortune's* "Most Admired Companies" and peer companies.

Methodology

The "Fiscal Management of Compensation Programs" survey was administered to approximately 5,000 WorldatWork members through a Web link. The survey opened in December and closed in February 2005. Hay Group also sent a Web link encouraging its registered Web-site users to complete the online survey during the three-month period.

More than 600 compensation professionals, typically managers or directors, completed the survey. Seventy-two percent of the respondents represented organizations with more than 1,000 employees. (See Figure 1.) Respondents from only 8 percent of the sample reported representing organizations with fewer than 100 employees. Figure 2 shows the diversity of the survey sample, which included respondents from manufacturing (18 percent); finance and insurance (16 percent); health care and social assistance (10 percent); and professional, scientific and technical services (10 percent). Respondents were excluded from the analysis if more than one manager responded for a single organization (the highest-ranking manager was retained) or if the organization reported it had fewer than 10 employees.

FIGURE 1 Company Size (Number of Employees) of Respondents

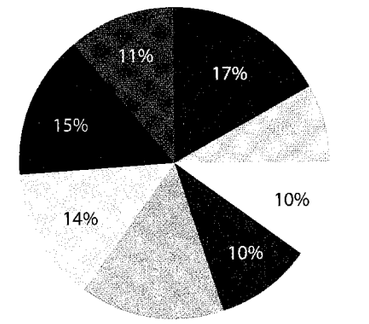


FIGURE 2 Industry Sector of Respondents

Manufacturing	18%
Finance and insurance	16%
Other	11%
Health care and social assistance	10%
Professional, scientific and technical services	10%
Educational services	5%
Public administration	5%
Other services (except public administration)	5%
Utilities	4%
Information	4%
Retail trade	3%
Transportation and warehousing	2%
Arts, entertainment and recreation	2%
Accommodations and food services	2%
Wholesale trade	1%
Mining	1%
Real estate and rental/leasing	1%

The survey queried compensation managers about:

- Their role in the compensation fiscal-management process
- How compensation expenses were budgeted and which fiscal-management tools were in place to control this expense
- Which pay and performance linkages were used to distribute pay
- The effectiveness of the fiscal management policies and practices currently in place.

The survey instrument required approximately 20 to 30 minutes to complete. Because an organization may have multiple compensation systems in place, compensation managers were asked to respond to the survey as it pertains to the managerial and professional employee population in order to enhance comparability across companies.

To provide a more thorough evaluation of compensation fiscal-management practices, companies identified by *Fortune* magazine as a "Most Admired Company" were compared to a sample of similar-sized companies that did not achieve this designation. The *Fortune* "Most Admired Companies" survey is a highly regarded annual analysis of corporate reputations by Hay Group. More than 10,000 executives, directors and industry analysts are involved in developing this ranking. The survey invites respondents to rate companies, overall and within industry groupings, on eight criteria ranging from financial soundness and use of corporate assets to quality of management and quality of products and services.

Researchers used statistical T-tests to compare responses between "Most Admired" and other companies, and to compare the fiscal policies of compensation programs that were rated effective, to those rated ineffective. All percentages at or above .5 are rounded up.

Research Findings

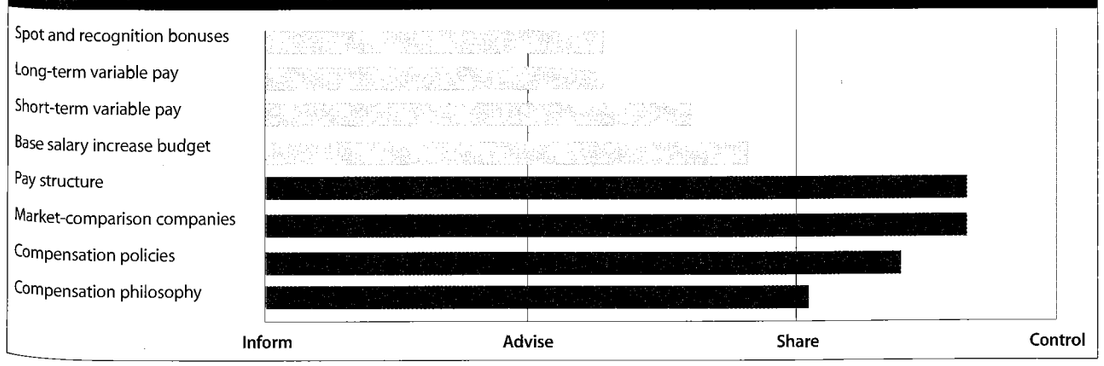
Role of Compensation and HR Managers

Compensation managers were asked to indicate their type of involvement in the design, administration and control of specific aspects of the compensation program for professional and managerial employees. For each attribute, they were asked to rate their influence on a five-point scale consisting of the following levels:

- Not involved
- Provides information to management
- Advises management
- Shares decisions with management
- Has primary accountability for the decision.

Findings show that relative to other leaders, compensation managers have the most direct impact and responsibility for designing pay structures, making comparisons to market data, establishing the compensation philosophy and setting compensation policies. (See Figure 3.) In fact, most compensation managers either share these design decisions with management or have primary responsibility for their design. In contrast, compensation managers have the least impact on

FIGURE 3 Compensation/HR Role in Program Design



designing spot awards, recognition and long-term variable pay programs. They are most likely to advise management or share in the decisions associated with those aspects of program design.

In addition, compensation managers are the primary decision makers in the placement of jobs into grades or the pay structure, according to the survey. (See Figure 4). They also tend to have significant accountability for administering market adjustments for hot skills, making special pay-equity adjustments, and establishing eligibility and target payout levels for short-term incentive programs (STI). Compensation managers have the least amount of authority for the administration of spot and recognition awards.

Compensation managers do not have as much fiscal-management authority for monitoring and controlling compensation expenditures. (See Figure 5). The data indicate that compensation managers are often in an advisory role to others in this regard — most likely to finance, which is usually responsible for controlling corporate expenditures.

The level of decision centralization is another way to think about compensation-program control. Figure 6 on page 17 shows that smaller organizations tend to have more centralized control then larger organizations. Interestingly, compensation managers rate programs that are more centrally controlled as less effective. In contrast, programs that are rated as most effective are decentralized to the local-unit level in more than 50 percent of organizations surveyed.

FIGURE 4 Compensation/HR Role in Program Administration

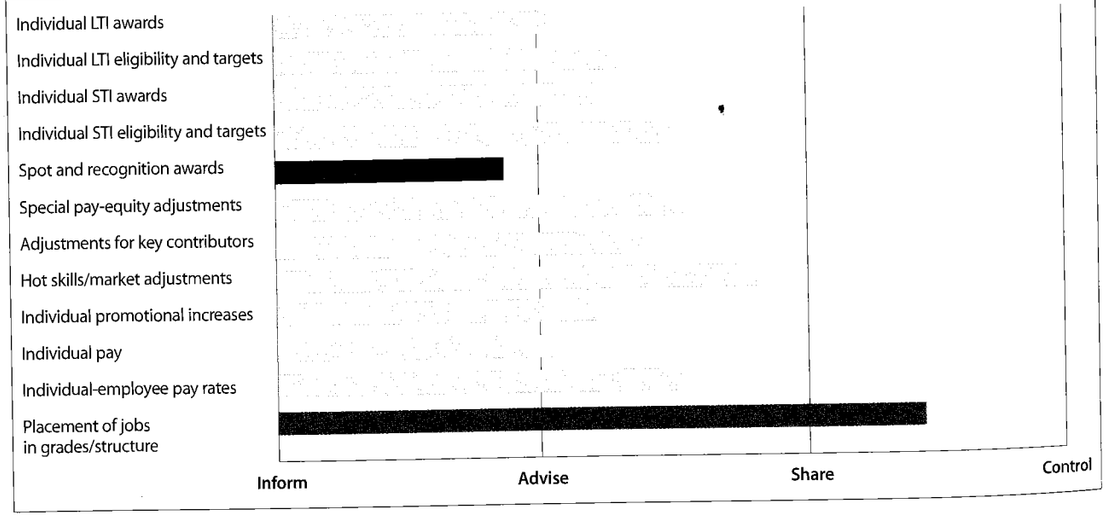


FIGURE 5 Compensation/HR Role in Program Design

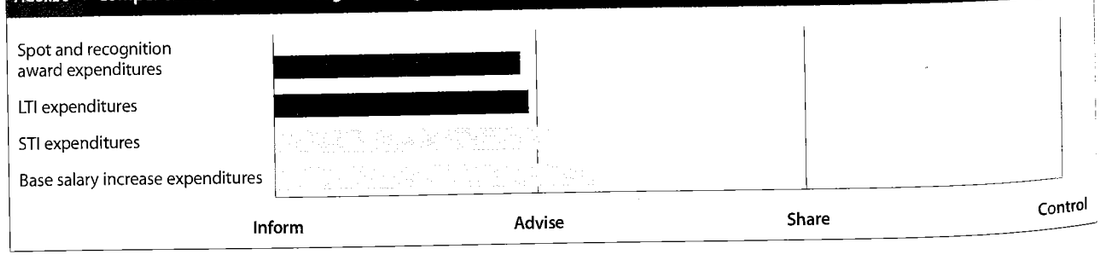
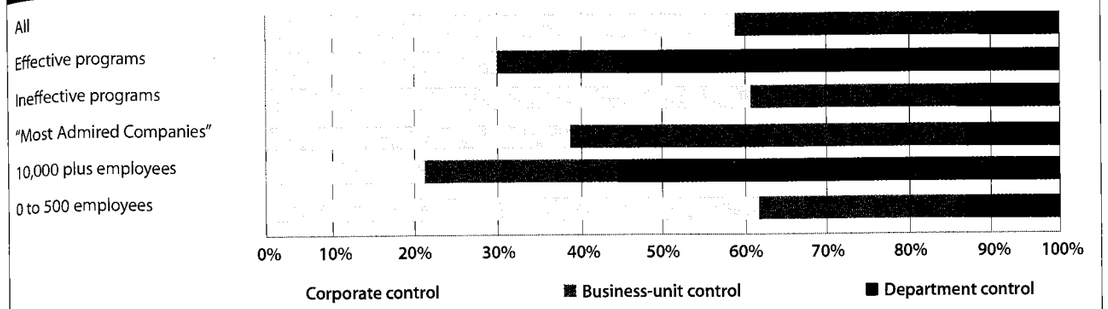


FIGURE Centralization of the Compensation Program



Compensation Budgeting

Research shows that most organizations analyze their compensation budgets element by element (56 percent). Only 19 percent of the compensation managers analyze and budget for total remuneration. Surprisingly, 23 percent of organizations budgeted for base salary only.

Figure 7 shows the budgeting process both in terms of how many organizations have certain types of compensation programs and the proportion of organizations that budget for the expenditures associated with those programs. Most of the survey participants use a wide range of compensation elements. Many organizations budget for these elements individually, and there is significant variation in budgeting practices, including these noteworthy examples:

While many organizations budget for internal equity, hot skills, and high-potential/key-contributor pay adjustments and increases, many others do not. If these increases affect a significant number of employees, the amounts could well be worth budgeting.

Researchers did not expect so many organizations to budget promotion increases for replacement promotions. Our experience indicates that these promotions generally

FIGURE 7 Compensation Budgeting

Compensation Element	% of Organizations	% Budgeted	% Not Budgeted
Base salary increases	99%	99%	1%
Promotion increases (for in-sequence/planned promotions)	95%	80%	20%
Promotion increases (for replacement promotions)	94%	71%	29%
Special internal-equity pay adjustments	91%	64%	36%
Hot skills/market adjustments	90%	60%	40%
Additional adjustments for high-potential employees or key contributors	90%	65%	35%
Spot bonuses and recognition awards	89%	82%	18%
Short-term incentives	87%	95%	5%
Payroll slippage and recovery (due to organization turnover)	81%	48%	52%
Long-term incentives	79%	92%	8%
Diversity-bases adjustments	69%	36%	64%

Prevalence

do not add costs, as the replacements tend to be paid less than the people they replace.

Past years' surveys have indicated a decline in the prevalence of budgeting for payroll recovery or slippage (the difference between actual year-end pay and expected year-end pay for a constant sample of jobs, which is caused by a variety of factors such as promotions, departures and new hires) though only anecdotally. Despite this decline, it was surprising to find that 52 percent of participants do not budget for slippage. The authors' consulting experience suggests that slippage can change payroll levels by as much as 1 percent.

Perhaps both the high prevalence of budgeting for replacement promotions and the low prevalence of budgeting for slippage reflect a new reality. Only 19 percent of participants report paying new incumbents less than the people they replace, and 72 percent report that actual salary-increase expenditures are approximately equal to budget. Organizations that report having effective compensation planning and budgeting processes do not show a higher prevalence of budgeting for slippage. However, 41 percent say new incumbents are paid less than the people they replace and 81 percent report expenditures being equal to budget. These organizations seem to be finding ways to identify and reallocate slippage, even though they do not budget for it.

Another interesting phenomenon associated with compensation budgeting is how organizations handle savings that result from temporary vacancies. Twenty-five percent of organizations use these savings to reduce overall labor expenditures, 11 percent plan for vacancies and include the savings in their budgets and 14 percent allow managers to use the savings for other purposes. (See Figure 8.) However, the survey demonstrates that the most prevalent practice among respondents (50 percent) is to have no consistent policy for dealing with this type of savings. This is a case where common practice does not equal best practice. Organizations reporting effective compensation planning and budgeting are much more likely to have a consistent policy (61 percent) than those reporting ineffective processes, of which only 37 percent have a consistent policy.

Given the commitment of financial resources associated with employee compensation, budgeting for employee salaries and wages is important. As reported by survey participants, the most important determinant of how much an organization is going to budget for salary increases is how much other organizations are budgeting (i.e., labor-market movement). The organization's ability to pay, its desired competitive position in the labor market and its financial performance represent a second tier of criteria — both in terms of prevalence of use by organizations and in the level of importance perceived by compensation managers. The three criteria that were seldom used to determine base pay increases and rated as having lower importance were cost of living, employee turnover and employee morale or satisfaction.

FIGURE 8 Treatment of Savings When a Position Is not Filled When Budgeted

	All	Not Effective	Effective
Reduces overall labor costs and credited as a labor saving	25%	18%	34%
A standard amount of salary savings are calculated into the salary budget (i.e. planning includes a certain number of unfilled positions.)	11%	5%	17%
Business unit or operations can use the salary saving for other purposes such as employee development, travel expenses, bonuses, etc.	14%	13%	10%
No consistent policy	50%	63%	39%

Base salary increase allocations are most often based on either a combination of individual performance and market position (56 percent) or on performance only (30 percent). Only 12 percent of organizations gives all employees the same raise, sometimes called a "general increase;" 1 percent determines increases based on competitive market position alone; and 1 percent bases increases on maturity curves or employee tenure.

Pay Structure

A total rewards philosophy suggests that rewards should be considered as a whole, including total cash compensation, employee benefits, desirability of the work environment, and training and career-development opportunities. While there is a great deal of attention paid to total rewards approaches by the compensation profession, survey results indicate that 80 percent of organizations set their cash compensation targets based only on the cash compensation marketplace, with no consideration given to the value of benefits, perquisites, work culture or training and development opportunities. This suggests that organizations are largely ignoring the notion of a total rewards model. Only 4 percent of the organizations say they raise their compensation targets in order to make up for a lower-than-desired competitive position against their benefits, perquisites or work environment. And 10 percent of the organizations say they lower their compensation targets to offset higher-than-desired competitive positions of their benefits, perquisites or work environment.

Organizations follow a variety of strategies in managing compensation within salary ranges. Sixty-three percent of organizations allow salaries to fall below the minimum pay range. These organizations treat below-minimum salaries in a variety of ways. Eighteen percent allow salaries below minimums solely for performance reasons, 23 percent have a policy to accelerate increases until salaries are within the range and 21 percent allow managers to determine the timeframe for moving salaries above the minimum.

Ninety percent of organizations allow salaries to exceed the maximum of the range. More than half (51 percent) freeze salaries that exceed maximums but give lump-sum merit payments or bonuses. Only 15 percent freeze salaries without lump sums. In 23 percent of organizations, salary increases are allowed even when salaries exceed range maximums.

Although organizations use a number of criteria for moving individual employees through the pay range, performance versus job standards is reported as both the most prevalent criterion and the most important. Position in range (relative position in the labor market) and performance relative to individual objectives are used frequently, but are considered less important criteria. Finally, time in the position and education level seldom are used to move employees through the range and are not considered to be important criteria.

In terms of fiscal compensation management, managerial discretion in granting pay raises is an

important issue. In 27 percent of the organizations surveyed, line managers determine how to use market references or compa-ratios to adjust pay. In 40 percent of the organizations, there are formal guidelines regarding market references or compa-ratios that the line manager must consider when adjusting base pay. In 33 percent of the organizations, market references or compa-ratios largely determine how base pay should be adjusted, with relatively limited managerial discretion.

Pay and Performance Linkages

Research indicates that employees often are skeptical that better performance will lead to better compensation (Hills 1987). According to Hay Insight's global employee opinion norms, 56 percent of employees do not agree that better performance results in better pay. (Hay Group, 2005). According to previous data, numerous factors lead to this skepticism among employees, including:

The relatively modest size of historic merit increase budgets

Lack of clarity in compensation and pay-for-performance objectives

Inadequate performance differentiation

The inadequate differentiation of rewards.

"Most Admired Companies," however, do tend to find a way to provide differentiation in rewards. In a 2002 survey of WorldatWork members, results show that *Fortune's* "Most Admired Companies" were more likely to differentiate base salary increases for outstanding performers (typically a 2X differential vs. a 1.5X differential) than companies that did not receive this distinction (Scott, McMullen, Wallace and Morajda 2004). Therefore, with a 4-percent merit-increase budget, outstanding performers in a "Most Admired Company" would average 8-percent increases, while outstanding performers in a typical company would average 6-percent increases.

One of the key reasons that many organizations are having a difficult time in differentiating pay for outstanding versus average performers is that they give base salary increases to virtually all employees, which quickly consumes the merit budget. The survey found that 68 percent of organizations give increases to between 95 percent and 100 percent of employees. Moreover, 95 percent of organizations give at least 80 percent of employees within the organization a salary increase.

The 2005 survey shows a striking difference in how two hypothetical organizations might differentiate pay for top performers. For example, Company A and Company B both have a 4-percent base salary increase budget. Company A provides an average 1.5X differential in base pay increase for outstanding performers (as shown in the 2002 survey report) and gives 100 percent of the workforce a salary increase. In contrast, Company B provides a 2X differential (in line with "Most Admired Companies") and provides increases to 80 percent of the workforce. In this example, Company A is able to give outstanding performers a 6-percent pay increase while Company B can give outstanding performers a 10-percent average increase.

Variable pay programs represent another key compensation program linked to performance. The funding of variable pay programs in large part indicates how costs are controlled within the organization:

- Nineteen percent of the organizations used discretionary funding, which was typically decided by management at the end of the fiscal year.
- Self-funded programs, typically financed through reduced costs or increased revenues/profitability (typically driven by formulas established in advance), were used in 23 percent of the organizations.
- In 35 percent of the organizations, a percentage of payroll is used to fund variable pay expenditures.
- Twenty-three percent of the respondents indicated that this question was not applicable or that they used a different method for budgeting variable pay.

To further ensure the fiscal management of variable pay programs, the overwhelming majority of plans make use of funding hurdles or triggers (84 percent), such as a minimum level of organizational financial performance before payouts occur. In addition, more than 90 percent of organizations make use of caps or maximums on variable pay plans that protect the business in the case of significant variation in organization performance that may not be solely caused by the actions of plan participants. While hurdles, targets and caps can be effective tools in the fiscal management of variable pay programs, they also can make the linkage between performance and pay less clear.

Figure 9 shows that a majority of the surveyed organizations base variable pay allocations largely on formulas (66 percent), but a noticeable minority use highly discretionary allocation processes (13 percent). The remaining 22 percent balance their use of payout formulas and management discretion. "Most Admired Companies" reported a greater use of management discretion in allocating variable pay, while organizations that view their fiscal management processes as most effective relied more on formulas and allowed less management discretion.

FIGURE 9 **Variable Pay Allocation Processes**

		All	Most Admired	Most Effective
Discretion	Variable pay program payouts are highly discretionary, and management has significant latitude in determining individual payouts.	13%	16%	9%
	Variable pay program payouts are generally balanced between formula and management discretion.	22%	32%	9%
	Variable pay program payouts are largely determined via a formula, but management discretion may change an individual payout to some degree.	41%	32%	52%
	Variable pay program payouts are typically driven from a formula that allows no management discretion in the individual payout.	25%	20%	30%

Effectiveness of the Fiscal Management Process

Compensation managers generally believe that compensation fiscal management processes are indeed effective. Between 63 percent and 79 percent of organizations rate their programs as effective, based on budgeting and planning, administration and control, the status of the compensation/finance partnership, and the timeliness and accuracy of compensation information. (See Figure 10.) However, methods used to reduce compensation expenditures were not rated highly by respondents. The strategy of not filling or delaying the fulfillment of open positions was the only cost reduction strategy that was widely used and effective; whereas all other strategies were rated as marginally effective. (See Figure 11.) This is likely due to the fact that keeping positions open has the least impact on current employees.

Researchers asked compensation managers how they judged the effectiveness of the compensation fiscal management process. Figure 12 on page 23 shows the prevalence and relative importance of criteria used to assess the effectiveness of the compensation program. Respondents indicated that top-line business operating results are the most prevalent criteria used to measure effectiveness. They also rated top-line business results as highly important. Employee retention is frequently used as a criterion but is not afforded as much importance as top-line operating results. Controlled or lowered labor cost is not as frequently used, but is considered an important criterion by those who indicated they use this measure. Informal opinion gathering from employees or the ability to recruit new employees are typically not used and given little importance by those that use this measure.

Return-on-investment (ROI) calculations are a key element of almost all investment decisions made in organizations, according to the survey. While organizations commonly use ROI analysis to justify capital expenditures, it is not used nearly as frequently for organizations' multimillion dollar investment in its workforce. As shown in Figure 13, the ROI of compensation programs is *not* calculated and evaluated in the majority of organizations (62 percent) and is done only informally by 20 percent of the organizations surveyed. It is interesting to note that both "Most Admired Companies," as well as organizations where fiscal management programs were rated as effective, attempted to use ROI evaluations more frequently than other organizations — especially those organizations where the compensation manager evaluated their fiscal control methods as ineffective. Perhaps this presents an opportunity for many organizations to view compensation as an investment rather than an expense.

Most organizations have financial reporting systems to monitor compensation expenditures (72 percent). However, of the compensation managers who deemed their fiscal management process ineffective, only 47 percent of them reported that they had a financial reporting system in place.

FIGURE 10 Treatment of Savings When a Position Is not Filled When Budgeted

	Ineffective	Marginal	Effective
Budgeting and planning process	6%	26%	68%
Administration and control process	6%	31%	63%
Role of human resources working with finance and management	6%	27%	68%
Timeliness of compensation information	4%	26%	70%
Accuracy of compensation information	3%	18%	79%

FIGURE 11 Methods for Lowering Compensation Costs

	Prevalence	Effectiveness
Don't fill or delay filling open positions	High	Effective
Reduce headcount	High	Marginal
Outsource employee work	Medium	Marginal
Offer retirement or severance bonuses	Medium	Marginal
Reduce employee benefits	Medium	Marginal
Delay pay increases	Medium	Marginal
Substitute FT employees with PT employees	Medium	Marginal
Freeze wages across the board	Low	Marginal
Freeze wages except in special cases	Low	Marginal
Encourage unpaid leaves of absence	Low	Marginal
Reduce pay across the board	Low	Marginal
Use selected employee pay reductions	Low	Marginal

FIGURE Criteria Used to Judge Effectiveness

	Prevalence	Importance
Top-line business operating results, i.e. revenues	High	High
Employee retention	High	Marginal
Controlled or lowered labor costs	Medium	High
Employee productivity metrics	Medium	Marginal
Bottom-line business operating results, i.e. profits	Medium	Marginal
Employee-satisfaction survey measures	Medium	Marginal
Informal opinion gathering from senior leaders	Medium	Marginal
Informal opinion gathering from employees	Low	Low
Ability to recruit employees	Low	Low

FIGURE How Compensation ROI Is Monitored

	All	Most Admired	Effective	Ineffective
We do this informally via discussions with management and employees.	20%	21%	19%	12%
We do this formally by comparing our investment in human capital to financial and productivity measures.	9%	21%	16%	5%
We do this formally via assessment of employee and management attitudinal data.	9%	18%	12%	7%
Not applicable. We do not attempt to assess ROI.	62%	36%	53%	77%

Compensation expenditures were monitored monthly by 51 percent of the organizations studied, quarterly by 21 percent, annually by 16 percent, only as needed by 9 percent and not at all by 2 percent.

Conclusions and Recommendations

The "Fiscal Management of Compensation" survey found that practices vary widely among those surveyed. However, different practices are not equally effective, and in some cases indicate that organizations have insufficient fiscal management tools in place. Results further indicate that compensation managers have a major role in designing and administering compensation programs. However, the finance function also plays a major role, especially in terms of monitoring and controlling compensation expenditures.

Most surprising is that not all organizations are budgeting for all elements of their compensation programs, or monitoring these costs frequently. In addition, pay ranges seem to be surprisingly porous — and pay ranges and compa-ratios seemingly would be the first line of defense in managing compensation decisions and allocating scarce funding most effectively.

Finally, most compensation managers consider their fiscal management policies and practices to be effective. However, the data indicates that fiscal management pay systems may be incomplete given how infrequently compensation managers use ROI calculation to control compensation-program costs.

Based on these findings, compensation managers could significantly enhance the effectiveness of their compensation programs if they integrated these suggestions:

- Use the notion of "total rewards" or at least total remuneration to compare compensation programs with those of other organizations.
- Review how compensation budgets are calculated and reported, determine which expenditures are significant and variable for their organizations, and budget for them.
- Increase the pay differentiation between employees who are average and outstanding performers. Carefully consider whether targets, hurdles and caps are necessary.
- Consider the use of ROI in developing and communicating compensation budgets.
- Consider how slippage affects the total compensation budget and may hinder the accomplishment of compensation goals.
- Carefully consider the use of salary ranges and manage compensation costs. Determine how to handle exceptions. WJ

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Editor's Note: The "Fiscal Management of Compensation" survey is available to WorldatWork members at no cost. To obtain your copy, go to www.worldatwork.org and click on "Library," then "Surveys/Research."

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