COMPETITIVE COMPENSATION

Strategy

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# Your Salary Administration System Is Out of Date

Incentive pay is outdating the traditional salary administration systems now in place. It's time to move to a total pay system.

Nearly 90 percent of U.S. companies offer some type of variable pay opportunity, and 40 percent are examining new areas to introduce incentives, according to recent surveys.* If employers do not consider variable pay elements in their daily pay administration activities, they risk losing control of a large part of their compensation expense.

Skill-based pay for technical jobs, gainsharing programs for production jobs, commissions and bonuses for sales jobs—are these programs unfairly providing larger compensation opportunities to parts of your organization?

Organizations go to great lengths to ensure that base salaries are internally equitable and competitive with the market. Job-evaluation plans, whether whole-job-ranking or computer-assisted, measure a job's value to the organization and then assign a base pay level that recognizes that value. But, as organizations put more base pay at risk and offer alternative compensation opportunities, base pay presents only a portion of the pay equity picture.

Compensation for jobs with large amounts of pay at risk, like sales jobs, has traditionally been difficult to administer under a standard schedule of salary grades and ranges. In fact, many organizations have developed separate salary structures for such jobs, ignoring the internal equity implications of such a move. The problems that organizations face with "incented" sales jobs are likely to spread to other areas of the organization as variable pay becomes more prevalent.

## *A total pay perspective*

The "target-earnings" concept is at the foundation of total pay administra-

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*Wyatt Data Services, 1991-1992 Survey Report on Variable Pay Programs and 1991-1992 Sales and Marketing Personnel Report.

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## EXHIBIT 1

### Total Pay Administration Plan

| Target Earnings (thousands) | | | Base Salary (thousands) | | | |
|---|---|---|---|---|---|---|
| **Grade** | **Low** | **High** | **Level** | **Min.** | **Mid.** | **Max.** |
| 1 | $20.0 | $22.9 | A | $16.0 | $20.0 | $24.0 |
| 2 | 23.0 | 26.4 | B | 18.4 | 23.0 | 27.6 |
| 3 | 26.5 | 30.3 | C | 21.2 | 26.5 | 31.7 |
| 4 | 30.4 | 34.9 | D | 24.3 | 30.4 | 36.5 |
| 5 | 35.0 | 39.9 | E | 28.0 | 35.0 | 42.0 |
| 6 | 40.0 | 46.2 | F | 32.0 | 40.0 | 48.0 |
| 7 | 46.3 | 53.1 | G | 37.0 | 46.3 | 55.5 |
| 8 | 53.2 | 61.1 | H | 42.6 | 53.2 | 63.8 |
| 9 | 61.2 | 70.3 | I | 48.9 | 61.2 | 73.4 |
| 10 | 70.4 | 80.8 | J | 56.3 | 70.4 | 84.4 |
| 11 | 80.9 | 89.9 | K | 64.7 | 80.9 | 97.1 |
| 12 | 90.0 | 100.0 | | | | |

tion. Target earnings for each job can be defined as the total pay the company would like the fully competent employee to earn in an average year. This value is equal to the base-salary-range midpoint plus expected incentive earnings.

Target earnings will be the same for all incumbents of a given job, regardless of individual or company performance. The target-earnings level for a job may consider marketplace total-cash-compensation practices, or internal job value, or both.

### *The fundamentals*

Under a target-earnings program, each job has a grade assignment that expresses both the base salary and target-earnings level. Both are necessary to successfully administer pay because each serves a different role. The target-earnings level communicates the value of the job to the organization based on its responsibility and expected contribution. The base salary level communicates the range of fixed or base pay associated with the job and helps managers control their fixed expenses.

Jobs assigned to the same target-earnings grade may have different base salary level assignments, depending on the amount of pay at risk. For example, an accountant and a sales representative may both be at a target earnings grade 4 (see Exhibit 1). However, the accountant may be at a base salary level D and the sales representative at a base salary level A.

Because the performance of the sales representative is potentially more variable (because of less supervision, fewer formal guidelines or less confidence in predicting the contribution of a job incumbent), the position's fixed base pay level is much lower. The organization expects the fully competent sales representative to contribute at a level equivalent to the accountant. In this example, the accountant's grade is 4D and the sales representative's grade is 4A.

Target-earnings ranges cluster jobs of equivalent value—they do not represent the expected range of total earnings. For example, target-earnings grade 12 (See Exhibit 1) will include jobs that have target earnings of between $90,000 and $100,000. Actual total earnings could be much lower or higher, depending on the incentive plans.

### *Developing the plan*

Organizations that base job value on the market should attempt to tie target-earnings levels to market total-cash-compensation data.

Once the target-earnings level is identified, the organization should determine the proper pay mix for the job—how much of the total earnings should be fixed or base pay and how much should be variable pay (incentive, commission or bonus). Proper mix can be a direct reflection of the marketplace or may relate to the confidence the company has in predicting the level of contribution of the job incumbents.

After determining the proper mix, the next step is to assign the job a base salary level that reflects the fixed-cost range for the job. For example, a job with target earnings of $44,000 and a target incentive of 10 percent will have a base salary midpoint of $40,000 and a range of $32,000 to $48,000. For jobs with no variable pay opportunities, the target earnings will be equal to the salary range midpoint.

Organizations that base job value on factor- or dimension-based job evaluation programs often assign jobs to a salary structure based on factor ratings and subsequent point values. Often the value, or weight, of a factor is established according to its relationship to market base pay.

As variable pay becomes more prevalent, base pay alone becomes a less accurate indicator of job value. Factor definitions and factor weights must therefore be calibrated to measure true job value as expressed in the target-earnings number. Factor regressions should attempt to predict market total cash compensation, not market base salary, and the resultant grade assignment should reflect target cash compensation.

### *Communicating the plan*

Target-earnings administration gives organizations an opportunity to communicate more information about compensation opportunities. All grades contain base salary and target-earnings compensation information. The base salary range should be communicated as the range of guaranteed compensation that the employee will earn on a regular basis (weekly, semi-monthly, monthly). The target-earnings grade represents the expected total earnings of a fully competent job incumbent.

A total-cash-compensation range can also be communicated. The total compensation range combines the base salary range with the incentive opportunity. The minimum will reflect the base hiring rate and will be equal to the salary range minimum. The maximum will be equal to the base salary range maximum plus the most an incumbent could earn under the applicable incentive plan. If an incentive plan is not capped, there will be no cash compensation maximum.

For example, based on the target-cash-compensation level of the job in Exhibit 2, the target earnings grade would be a 6 (target earnings of $44,000 falls in the $40,000 to $46,200 grouping of grade 6), while the base salary level is an F. This job would be communicated as grade 6F.

## *The payoff*

Total pay administration requires a change in the mind-set of every employee. When employers treat all compensation dollars equally, those areas with lucrative incentive plans and high target earnings must account for contribution levels that justify the expense.

Managers who wish to introduce incentive plans must examine the consequences of putting some guaranteed pay at risk. However, in return for this change in mind-set, total pay administration offers many benefits:

**Ensures total pay equity across the organization.** The target-earnings levels reflect true job value to the organization because they ignore pay mix and focus on the total-cash-compensation level the company expects to provide each job.

**Communicates promotional opportunities.** Grades based on target-earnings clarify promotional opportunities between jobs that are heavily incented and those that are not heavily incented. Under traditional plans, varying amounts of pay at risk may have made it difficult to discern whether a job change was actually an advancement.

**Prevents the use of incentives as "add-ons" to base salary.** The target-earnings level for a job does not change if a new incentive is introduced or if an old incentive is phased out. Introducing an incentive means lowering base pay, and eliminating an incentive may mean raising base pay. Unless a job's expected contribution changes, the target earnings will remain the same.

**Supports increased use of incentive plans.** As the company introduces pay-at-risk programs to new areas of the organization, employees may be more comfortable if they see that their target-earnings grade has not moved, even though their base salary grade is lower. (Of course, in exchange for a lower base salary grade, the employee's total earnings potential should be raised.)

**Allows accurate tracking of unit compensation costs.** Budgeting and tracking target compensation force managers to think through the role of base salary, the role of incentives, the appropriate pay mix for their function, and the total anticipated compensation costs for the budget period.

**Provides a good measurement for determining benefit levels.** Because target earnings are a better measurement of job value, benefits and perquisites are more equitably tied to target earnings rather than to base salary.

**Communicates total earnings opportunities to employees.** The communication of total target earnings and the possible ranges of cash compensation will provide employees with a better appreciation of their total earnings potential.

**Provides a more useful definition of compa-ratio.** As base salary is de-emphasized, traditional compa-ratio analysis (comparing an employee's base salary to the base salary range midpoint) is less meaningful. However, comparison of actual total cash compensation to target earnings may reveal if the administration of total compensation is equitable across the organization. If one unit's ratio is significantly higher than another's, you should expect performance in that unit to be significantly higher. If this is not the case, you would examine whether base pay is too high or whether incentive plan performance targets are too easy to achieve.

**Focuses salary planning efforts on total pay increase costs.** Each year, organizations collect merit budget survey data to help them determine the size of their salary budgets—adjustments to base salaries and base salary ranges. Adjustments have recently ranged from 4 percent to 6 percent, depending on geography, industry, organization size, etc. In selecting an increase figure, organizations recognize the significance of .1 percent or .2 percent, but few include the impact that increasing base salary levels has on incentive payouts.

A 6 percent base salary increase will probably trigger a 6 percent increase in the incentive earnings of a bonus-eligible position—an enormous hidden cost. A truer reflection of change in compensation expense would be gained by examining expected changes in total cash compensation.

## *In conclusion*

Incentive pay is penetrating the ranks of many organizations and outdating the salary administration systems now in place. Jobs with different levels of pay at risk suggest that pay equity cannot be attained by focusing on base salary levels. A target cash compensation system may be slightly more difficult to administer, but the administrative requirements are offset by the advantages of total pay equity, total pay communications and greater cost control. ■

### EXHIBIT 2

**Example of a Grade 6F**

| | Earnings Range (thousands) | | |
|---|---|---|---|
| | Min. | Target | Max. |
| Base salary | $32.0 | $40.0 | $48.0 |
| Incentive opportunity | 0.0 | 4.0 | 10.0 |
| Total cash compensation | 32.0 | 44.0 | 58.0 |