What Every CEO Should Know

About Employee Pay

Many executives continue to manage pay the way they have seen it managed in the past – in organizations they've led and through industry "best practices". But compensation is not a one-size-fits-all endeavor and some critical thinking around common pay practices is called for.

Below are some recommendations for consideration – some alternative thinking in areas where executives frequently rely on what they think they know, but would be better served with some new approaches.

EXECUTIVE SUMMARY

1 – Talk about "cost of labor" not "cost of living"

2 – Don't assume that the "average" pay increase works for all jobs

3 – Show your managers how their pay decisions compare to those of others

4 – Increase pay satisfaction without spending money by talking to employees about pay

5 – Identify reliable, relevant sources of pay data (good salary data is not free)

6 – Engage compensation experts to make your life much easier

7 – Don't clone another organization's pay or incentive plan - it rarely works well

8 – Know why applicants join your organization and why employees leave

9 – Don't rely on pay increases to keep employees engaged and happy

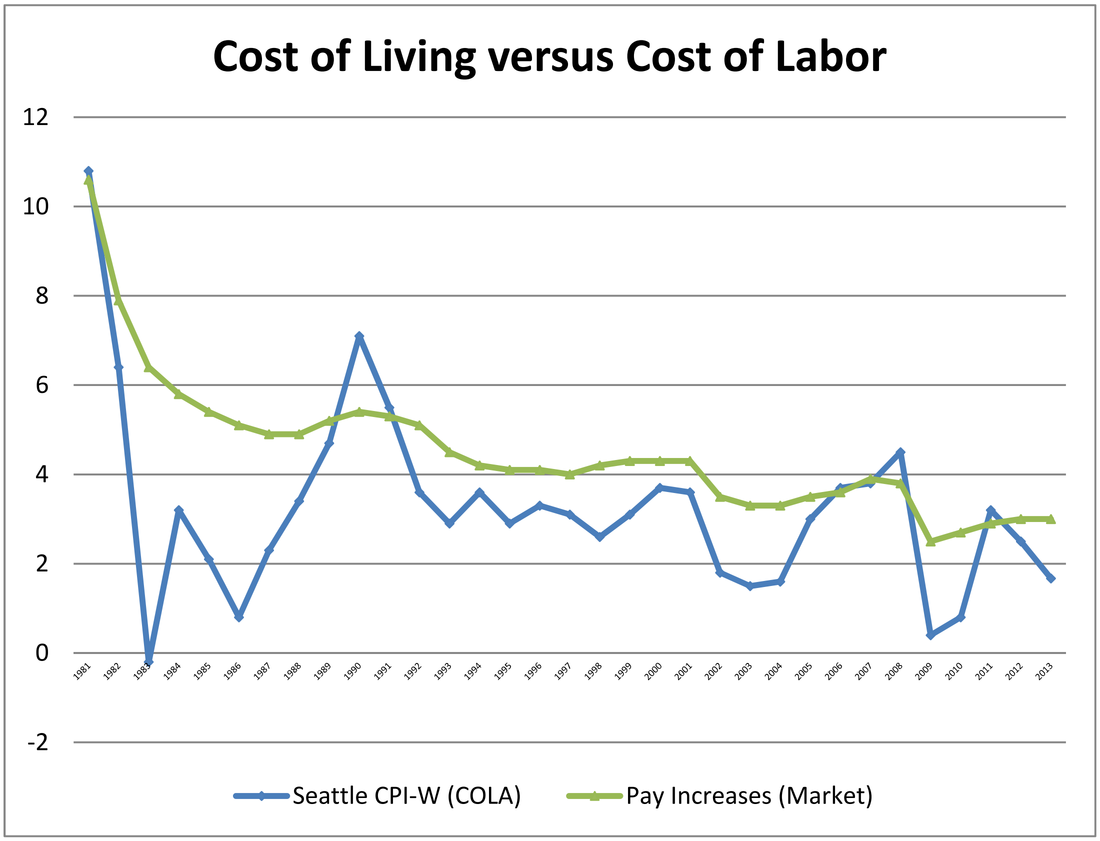
1. Talk about "cost of labor" not "cost of living"

A question managers are commonly asked is why a company's annual merit increase budget is different from annual inflation numbers. For companies using a market-based approach, answering this question requires an understanding of the difference between the "cost of living" and the "cost of labor."

"Cost of living" reflects the costs of goods a typical consumer uses including housing, groceries and transportation. Changes to these costs are most often reported through the consumer price index (CPI) which is updated monthly. While these changes are determined by the various factors at play in the marketplace, there is not always a direct and distinct link between the cost of living and pay.

"Cost of Labor" looks at the pay rates for a specific job/skill at your company and compares them to the pay rates for similar jobs elsewhere. Through a market analysis, a company can identify the "cost of labor" a particular geographic market offers as compensation for a particular type of work. When pay rates for specific jobs in specific locations are tracked and compared to the previous year's pay levels, the change is the cost of labor.

If there are more people available for similar work in a geographical area, it will hold the labor costs low. In contrast, if there are not enough people with the skill sets needed, the cost of labor will increase. This dynamic is separate from "cost of living" analysis. There can be correlation between the two, but they are not the same, and you can see that in this chart.



We caution employers not to confuse the two terms when making pay decisions. CPI can fluctuate significantly month to month and we have seen companies give their employees a cost of living increase only to have oil prices continue to rise the next month. They've had lines of employees out their office asking for additional increases mid-year due to the increased cost of living where the actual cost of labor remains relatively stable.

Even in environments where union contracts have a cost of living provision that provides annual pay adjustments between contract negotiations, when the contract comes up for renewal, both sides go out and gather current salary survey information to inform them about appropriate pay rates.

Merit increase budgets are ideally set considering the cost of labor as reported in market salary budget surveys each year. This information is readily available and can be found by doing an online search for “compensation trends” or “salary budget projections”. Make sure you are looking at your location and your industry as the numbers can vary significantly by region and by sector. Compensation Works also completes an annual compensation trends survey each year and includes this information on our website.

Remember, how you speak about annual increases can minimize the confusion. We encourage you to be careful and intentional about how you use the terms “cost of living” and “cost of labor.” If you provide flat organization-wide annual increases, you can call them “annual adjustments” or “across-the-board” adjustments instead of “Cost of Living” adjustments. It’ll save you headaches in the long run.

2. Don’t assume that the “average” pay increase works for all jobs

In most businesses, labor is the biggest overall expense. Except for some businesses with high capital costs, the majority of businesses have labor costs that run 40% to 70% of total expenses. Take some time to think about the percent of operating expenses that are labor costs in your organization.

Frequently, companies put this significant annual expenditure on auto-pilot. This is with a $6 million or $60 million or $600 million ANNUAL expense! They assume a 3 or 4% annual increase to this cost without ever taking a look at the underlying expense and whether or not the money is being spent in alignment with their organizational goals and values. If this annual expense were an annual capital expenditure, there would be much more scrutiny and analysis going into the decision.

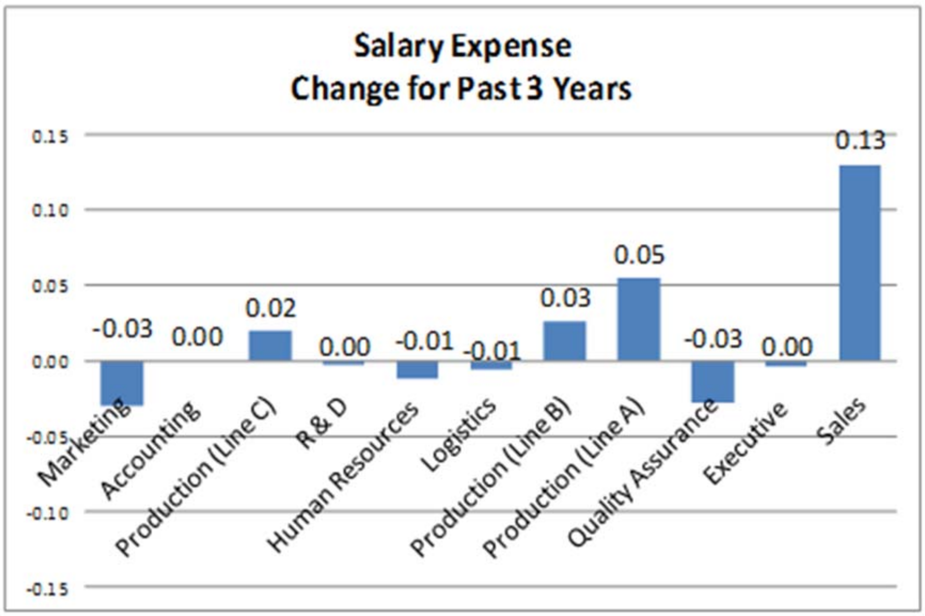
Putting your compensation plan on auto-pilot is an expensive way to “save money”. Some due diligence is needed to ensure that you’re getting the best result you can from this huge annual expenditure.

3. Show your managers how their pay decisions compare to those of others

Internal inequity creates 70% of employee dissatisfaction with pay. So while an employee may be irritated that the folks at Google or Microsoft are making more money than he is, he’s REALLY frustrated when it’s the guy on the other side of his cubicle who is making more.

Compensation decision-makers often have very different approaches when it comes to employee pay decisions. Some are overly generous and others are overly conservative. Rather than having discussions about which approach is right, develop a comparative report that shows average pay increases by department, number and cost of promotions, and the overall comparatio by department. Comparatio is simply a way of comparing the pay range to actual employee pay. In this example, an employee's comparatio is determined by dividing the actual salary for that person by the pay range midpoint. These figures can be aggregated for departmental and organization comparisons. If all your employees were paid at the midpoint of the range, the comparatio for your organization would be 1.0. If your employees were paid close to the maximum the comparatio might be 1.20 or 1.25. If employees were paid closer to the pay range minimum, the comparatio might be .75 or .80. Using comparatio as a tool allows leaders of organizations to evaluate trends in paying above or below pay rates of peer groups.

You can also share the pay increase changes. Here's an example of how that might look:



This chart clearly shows that Sales has had more increases than any other department in the organization. There may be a great reason for this; new hires, exceptional performance, different skill sets required that weren't previously.

If there is not a good reason for the disparity, this gives the executive team an opportunity to talk about what's going on. Most executive teams become self-regulating if you give them good information.

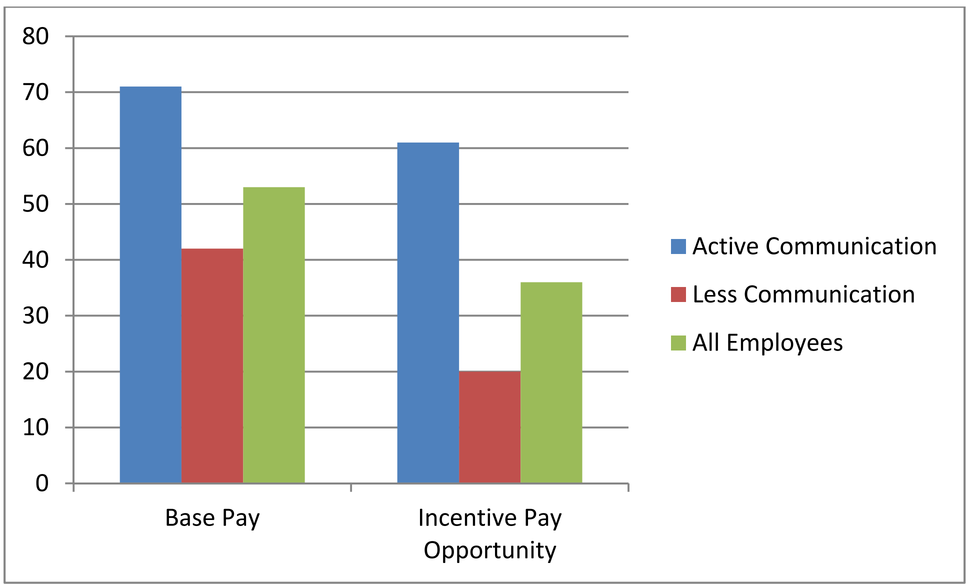
4. Increase pay satisfaction without spending money by talking to employees about pay

Many of us were trained that it was improper or inappropriate to talk about pay, or for employees to talk among themselves about pay. Some of us don't realize that non-supervisory employees must not be barred from talking about pay because it is a protected concerted activity according to the National Labor Relations Board (NLRB).

In addition, employees today have unfettered access to pay information on the web. Even if an employee is not looking for salary information, if they are online very long they will see an ad asking if they are being underpaid. The internet is inviting people to question their compensation.

Research shows that employee pay satisfaction is directly correlated with the amount of communication that happens about pay inside the organization. So you can actually end up paying less money for employees and have them happier about their pay if you effectively communicate about it.

EMPLOYEE PAY SATISFACTION



The world is different today than it was 10 years ago. Whether we like it or not, employees will have access to salary information. The "salaries are a black box" mentality is outdated. You want employees learning about their pay and career opportunities from you, not the internet.

5. Identify reliable, relevant sources of pay data

The internet has data available on pay rates for almost every job out there, with pay rates for the same job that are wildly divergent. When preparing for participation in performance and pay related conversations, that is exactly what many of your employees do – search for pay rates online. They find the highest data and bring that in to bolster their case for pay increases. If employers respond to this data, they are making pay decisions based on data that is invalid or inappropriate for the company.

We recommend that organizations identify 3 to 5 survey sources that cover the majority of their jobs. Some organizations will need to have surveys that cover different groups of jobs such as IT and Loan Officers. The surveys should be compiled and published by an independent third party. The survey should be conducted annually or at least bi-annually and, to ensure relevance, should include a large number of participant organizations that compete for the same labor talent that you do.

Once salary surveys that fit your business are identified, use those same survey sources each year to make pay decisions. This way, when an employee comes to you with internet data, you can say “Yes, that is interesting data. However, everyone in our organization has their pay set using the same methodology and these data sources.”

Most of the “free” data on the internet is worth exactly what you pay for it. If you look at the cost of reliable published survey data in relationship to your total payroll cost, it is usually less than a fraction of one percent of your *annual* payroll spend. A few thousand dollars to ensure that your multi-million dollar salary expenditure is correct is very cheap insurance.

6. Engage compensation experts

Compensation design is a very specialized function, much like tax accounting. Most organizations have both a CFO and a tax specialist or tax accountant; using these tax specialists because they are technical experts who stay up to speed on the latest regulations and deductions. They are likely to know where potential problems exist and where opportunities lie.

Like tax accountants, compensation design specialists will work on a dozen new plans in any given month and know where problems are likely to exist and where opportunities lie. Most HR professionals have managed and administered pay plans, but very few have much experience designing pay plans, especially a new plan.

It’s important to remember that compensation plan design is not just about a spreadsheet. It’s about how the program integrates and supports your business model, and how it impacts the bottom line of your business.

So next time you need compensation work done in your organization, think about who is best suited to do the work. Many times an expert, objective resource is your best bet.

7. Don't clone another organization's pay or incentive plan

Frequently, when we ask a new client how they got the pay system they currently have in place, we hear "well, it was the plan they had at ABC Company and it worked there, so…" Taking someone else's pay plan and launching it in your business is like taking a muffler off of a Volvo, putting it on a Toyota. It rarely works well and often requires a lot of bailing wire and duct tape.

It's important to remember that your business strategy, your market placement, your culture and core competencies are different than your competitors. Your pay system should be different as well. If all you do is use a single survey tool to determine your pay placement, you are allowing your competitors to set your pay strategy and rates for you. The market information simply shows what others do, but not what works well. Make sure that your pay program supports YOUR unique business strategy.

8. Know why applicants join your organization and why employees leave

Research show that most managers assume that employees decide where to work based on the reputation of the company or the company culture. But research also shows the top reason high performers and average employees choose to join an organization – the actual top reason - is the nature of their work. The second reason top performers and average employees chose to join an organization is because of base pay.

You must get base pay right to be able to attract top performers. Know the role compensation plays in their decision making and other factors you can influence, in concert with pay, to attract the best talent. And ensure that all of these factors align with your organizational culture and goals.

You should also investigate why high performers leave. Managers assume it is because of pay. But research shows that the number one reason top performers and average employees alike leave is because of stress levels at work. Average employees list base pay as the second most common reason they leave an organization. But top performers are more focused on promotional opportunities, career development opportunities and incentive pay opportunities. Base pay isn't even in their top 5 reasons for leaving.

Remember that your managers are likely to want to throw money at the problem when what is needed is a different approach to the work. It's much harder to fix, but often less expensive.

9. Don't on rely pay increases to keep employees engaged and happy

Some managers assume that if they just pay their staff more their employees will stick around indefinitely. Years ago Fredrick Herzberg's research revealed that pay is a "hygiene factor." If pay is too low or is perceived as too low, then it's an issue. However, high pay does NOT correlate to job satisfaction. So paying significantly higher than other employers does not help with employee retention or employee satisfaction.

More money won't offset the annoyance of having a jerk for a boss or a difficult work environment. A pay increase feels good at the time of the increase, but it soon becomes the "new normal."

We've all worked with employees who can't afford to quit because they can't make as much money anywhere else. These golden handcuffs can create miserable employees who make others in the organization miserable as well.

While it's fine to be a bit generous with pay, being overly generous increases your cost structure and has some big downsides. Make sure you check the market pay rates for your jobs so that you aren't spending your labor dollars on golden handcuffs.
