Direct Compensation: Investment Or Expense?

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How do employee wages impact your organization? To the payroll manager it means a job. To the controller, it is considered an expense. To the business development officer, it signals a growth opportunity. Of course, direct compensation is all of these, and more. In fact, a more appropriate title perhaps would be "Direct Compensation: Investment AND Expense!". More to the point, how an organization views this subject explains a lot about its goals and values. The following collection of articles explores several characteristics of compensation, including its design, measurement, and compliance, as well as alternatives, and trade-offs.

Included in this topic are the following parts:

- Salary Surveys: Enter at Your Own Risk
- Wage and Salary Bootcamp
- Nonprofit Alert: The IRS Means Business!
- Fixed vs. Variable: Plusses and Minuses
- Human Capital - Metrics Matters

Salary Surveys: Enter At Your Own Risk

Occasionally, I am asked, "What's wrong with setting my company's salaries by just duplicating my competition?" This quick and dirty approach is market-based, usually can be implemented quickly, and is typically inexpensive. On the other hand, these advantages can be outweighed by the potential downside risks. Those disadvantages are centered both in the nature and use of the salary survey, itself, which also is where you can get into trouble in subtle ways.

Let me pause here to say that surveys serve a useful purpose, but they need to be carefully scrutinized and analyzed by a trained professional.

Inherently Skewed

Surveys can have inherent biases, caused by job level, industry, market segment, or geography among reporting participants. Some surveys use only midrange positions from a job family and completely ignore junior and senior variations. What's more, certain breakouts can have a compounding effect. For example, a positive correlation can exist between company size and location, with larger firms tending to be found in larger metropolitan areas. Without appreciating the characteristics behind the data base, you would be ill-advised just to copy its conclusions for your own use. It sounds basic, but I am amazed at the number of organizations which don't follow this principle, all the while slowly developing inherent problems.

Problems

Due to the elapsed time to collect and report the data, published studies typically will understate current practices. Then there's also the length of time it has sat on your own shelf before you actually dust it off. To counter this, organizations are known to inflate the survey data by a cost of living factor. However, CPI figures typically overstate overall compensation trends, because aggregate payrolls tend to lag overall inflation. That is, through attrition experienced workers at high salaries tend to be replaced by less experienced employees at lower salaries. For this reason, firms need to be careful not to confuse average merit increases with salary scale structural movements. Historically, structural increases lag about 1% behind average merit increases.

Organizations occasionally are unsure of which CPI figure to use -- CPI-U or CPI-W? Adding insult to injury, the federal government, itself, has acknowledged that the CPI formula overstates inflation. Finally, adjustments to published data need to be made from the average experience date; some employers make the mistake of trending instead from the published date.

Reoprting Issues

How companies submit data also can become a problem without even realizing it. For example, a survey can be a mixture of employers which pay bonuses and those which don't. From a Total Compensation standpoint, some employers may be noted for low salaries and high benefits (or vice versa). Focusing only on salaries can skew the results. As broad based banding becomes popular, this is another area where surveys may be capturing both apples and oranges. Even those employers which submit good data do not always submit actual pay ranges.

Uniquenesses

A collection of positions may not offer a good match within a single survey, and the natural tendency then is to use multiple sources. However, rather than solving the problem, this can introduce new difficulties by mixing results and by injecting inconsistencies. Other challenges can arise when an organization mixes elements of several positions into one. Against which one in the survey should you compare? Some organizations get around this by using a "market basket" approach -- that is, by taking weighted averages of time spent on each duty. However, this middle ground may underprice those elements where specialized experience is required to attract interested candidates, especially in the case of smaller employers. Additionally, it is possible that certain positions reported in the survey are in fact combinations, themselves, in ways you are unable to detect once published.

Publisher Choices

Some surveys are based on the actual raw data, while others are based on smoothed, averaged, or aggregated data. The effect among surveys may be a variation in the mean salary and range for a particular position, even assuming identical data.

Preferred Solution

In "big picture" terms, surveys are designed to get you in the ballpark, not to provide precision. Instead of relying solely on market data, the preferred approach is to determine a point factor system internally, and then to use "real world" comparisons in the form of salary surveys. In this way, internal equities are confirmed by external marketability. However, the number of positions or your budget may not permit this level of detail. In that event, relying solely on salary surveys should be left to an experienced professional.

WAGE AND SALARY BOOTCAMP

Even organizations which avoid common compensation mistakes still can have trouble seeing the forest from the trees. In that event, it often is helpful to take a step back and reconsider the basic building blocks. Many have found the following overview to be a helpful "pathway" out of the woods.

Compensation Policy

Wage and salary administration is one of the most important components in any employment relationship. Unfortunately, it can be the one most easily taken for granted, probably because it lies at the crossroads of so many important parts of the organization. A compensation policy statement is vital in clarifying an employer's values. Such a policy:

- needs to enhance the organization's ability to attract and retain qualified employees;
- needs to be perceived as fair and equitable by employees to insure that morale is maintained;
- needs to afford a level of pay which insures there is effective control of labor costs; and
- needs to be in compliance with a variety of federal and state regulations.

In spite of the rise of on-line salary data, studies show that employees consider internal comparisons more critical. Employees have a fairly accurate idea of what others in the same organization give in exchange for what they get. However, this relationship is not at all apparent across organizations. For this reason, employers should pay more attention to internal pay issues than whether their employees are downloading questionable salary comparisons off the Internet.

Sound compensation programs incorporate five important steps.

Step 1: Job Analysis

I am convinced that may organizations start off on the wrong foot. They jump into training, labor relations, and compliance before deciding on their jobs' requirements. There is wisdom in the old saying, "if you fail to plan, you plan to fail." Planning should start with a systematic study of jobs. It doesn't have to be fancy, but a job analysis needs to answer a number of specific questions:

- What does the job require to be done, and why?
- What is used to accomplish it?
- What does the the job holder need to know?
- What responsibilities does the job holder assume?
- What working conditions require special personal qualifications?

Professionals use a number of methods to obtain job analysis information. By frequency of use, they are: interviews, observations, questionnaires, supervisory conferences, and check lists. (Interviews are popular in about 85% of salaried job analyses but only in about 30% of hourly job analyses.)

Most organizations develop job descriptions directly from information gathered this way. One technique is to identify the Major Job Functions (MJF), meaning the five or six most important divisions of the job. Within each MJF, significant tasks are then identified. For efficiency sake, both the MJFs and significant tasks are writen in short, terse statements beginning with an action verb.

Step 2: Job Descriptions

Normally, the results of the job analysis lead to a written job description. Many people have difficulty writing job descriptions simply because they do not conduct a thorough job analysis first. Although do-it-yourself job description software has created the allusion of high quality, without prior analysis most jobs written this way will suffer from misalignment. There is no right or wrong format for job descriptions, but most consist of the title, purpose, nature / scope of duties, and minimum specifications required to perform the job.

Step 3: Job Evaluation

There are four basic methods of "job evaluation" - that is, a formalized method of determining the relative worth of a job to the organization.

- Ranking: jobs are listed subjectively from low to high.
- Classification: jobs are sloted into an appropriate grade (predefined by level of difficulty).
- Point System: jobs are compared by common factors such as education, experience and complexity of duties. The factors and weighted, divided into degrees of difficulty, and points are assigned in a way that leads to the job's overall relative worth.
- Factor Comparison: a combination of the Ranking and Point System methods. Each job is ranked item-by-item on the four universal factors of responsibility, mental, physical and skill. Values for each are added to obtain the total value of the job.

Step 4: Salary Surveys

Surveys of other employers are essential after completing a job evaluation. To insure nonunion employees are being paid fairly, survey data must be reviewed at regular intervals. However, numerous analysis pitfalls need to be avoided.

Step 5: Communication To Employees

Because of the emotional side of pay, great pains should be taken to insure that employees understand compensation policies. Continuing communication is equally important, so that employees can realize that all pay decisions are fair and consistent.

NONPROFIT ALERT: THE IRS MEANS BUSINESS!

Reasonable Compensation

Congress passed "Taxpayer Bill of Rights 2" in 1996, proposing regulations authorizing the IRS to impose penalty taxes on certain nonprofit compensation defined as excessive. Details were published in IRS Notice 96-46 and Federal Register 8/4/1998. Over the next several years, the IRS solicited public input on the subject, resulting in final regulations being published in the Federal Register 1/10/2001.

The new rules have added a layer of compliance and administrative complexity to the operations of most nonprofits. More significantly, they impose sizable penalties on individuals for noncompliance. For those reasons, the new standards need to be taken seriously, although many nonprofits are still unaware the requirements even exist.

Recipients At Risk

The regulations apply to most public charities exempt under Section 501(c)(3) and social welfare organizations exempt under Section 501(c)(4). They are not designed to apply to private foundations, which instead are subject to a parallel set of rules on the same subject. The IRS uses the term, "disqualified person", to identify those at risk of having to pay the penalty tax. Private foundations have been regulated under a similar definition, but the scope for public charities is much broader. Stakeholders may fall into several categories, including:

- Officers, managers and supervisors,
- Directors and trustees, and
- Others who over the preceding five years were in positions to exercise substantial influence over the affairs of the organization.

Administrators At Risk

Also, certain employees personally may be subject to fine for administering excess benefits for others. *Exception: employees who rely in good faith on certain independent compensation expertise, such as from experienced consultants.*

The Problem

The Excess Benefit Tax is based annually on total compensation (salary, benefits, and other remuneration whether as an employee or not) on and after 9/14/95. Yes, retroactive to 1995! The rules provide guidance on what constitutes unreasonable compensation and improper behavior. They also provide "safe harbors" and "rebuttable presumptions".

Who is susceptible? The vast proportion of an organization's stakeholders. Consider the following possible examples.

- Employees receiving accelerated compensation to make up for prior periods of below-market salary.
- Development officers compensated on the basis of the gift or grant dollars they bring in.
- Boards of Directors and volunteers receiving compensation beyond the best practices in the marketplace.
- New hires receiving large signing bonuses or sizable in-kind remuneration.
- Older employees covered under rich traditional pension plans, and employees receiving heavily subsidized health insurance benefits.
- Payroll and compensation personnel involved in the adminstration of these sorts of potential problems.

The Solution

Because the possible problems are so pervasive and the potential penalties are so severe, most organizations will benefit from the following rules of thumb.

- Assume you are affected.
- Engage a knowledgeable, experienced professional, both for compliance reasons and for training purposes.
- Plan in advance, keeping detailed records and Board minutes.
- Implement a check-and-balance process to minimize future difficulties.
- Quantify your exposure to prior transactions which may have placed stakeholders in jeopardy already.

FIXED VS. VARIABLE: PLUSSES AND MINUSES

A Matter Of Balance

How does an organization go about deciding how to balance base salaries with incentives? Although there are a number of aspects to consider, many employers forget to align variable compensation with organization affordability. Consider the following simple example of how blind reliance on variable compensation can impede a company's expansion during times of growth.

	Year #1		**Year #2**		**Year #3**	
	Co. A	**Co. B**	**Co. A**	**Co. B**	**Co. A**	**Co. B**
[1] Revenue	$100	$100	$200	$200	$50	$50
[2] Fixed Comp	$40	$60	$60	$90	$40	$60
[3] Incentive Comp	$40	$20	$80	$40	$20	$10
[4] Profit	$20	$20	$60	$70	-$10	-$20
[5] Percent Profit	20%	20%	30%	35%	-20%	-40%

Company A: $40 and 40% of [1], Company B: $60 and 20% of [1]

[4] = [1] - [2] - [3], and [5] = [4] / [1]

First Year

Consider Companies A and B, identical operations with the only cost being payroll. In Year 1, Company A's compensation program contains two pieces: $40 (fixed) plus 40% of gross revenue (variable). Company B's program is similar, but the proportions are different: $60 (fixed) plus 20% of gross revenue. Both companies show 20% profit margins for the first year.

Second Year: Expansion

In Year 2, revenues double. Because theirs is a labor-intensive industry, both companies expand their employment bases. Each does so by 50%, in anticipation of the upcoming growth opportunity. However, Company B is more profitable because of its compensation design. Although the total compensation program under Company B does not provide the same degree of personal opportunity as Company A during such times of expansion, its base salary actually appears more competitive ($90 vs. $60). Note that in times of profitable growth, Company A is hurt twice -- once by lower profitability, and once by the perception of uncompetitive (base) salaries.

Third Year: Contraction

In Year 3, revenue declines substantially. It is now Company B which suffers, because of its heavier emphasis on the fixed element. (The example also assumes that the level of staffing in Year 1 is the minimal level which can be maintained for the long term. For this reason, both companies are assumed to cut back from Year 2 to Year 3, but not belowthe level of Year 1.) In the third year, incentives are paid even though both companies show financial losses. This is a classic case of misalignment, since employers should design their incentives in such a way that employer-vs.-employee results are either consistently win/win or lose/lose scenarios. Under the above designs, employees who receive incentives while the business loses money eventually may find themselves laid off. Alternatively, employees whose incentives drop sharply while their employers recognize rich bottom lines will tend to grow impatient and look for employment elsewhere.

Alternative

Fortunately, there is a better alternative. Instead, the companies might have chosen to express their incentives on the basis of *gross margin* (revenue minus fixed salaries) rather than on straight revenue, for downside financial protection.

	Year #1		**Year #2**		**Year #3**	
	Co. A	**Co. B**	**Co. A**	**Co. B**	**Co. A**	**Co. B**
[1] Revenue	$100	$100	$200	$200	$50	$50
[2] Fixed Comp	$40	$60	$60	$90	$40	$60
[3] Incentive Comp	$24	$24	$56	$66	$4	$0
[4] Profit	$36	$16	$60	$44	$6	-$10
[5] Percent Profit	36%	16%	30%	22%	12%	-20%

Company A: $40 and 40% of [1] - [2], Company B: $60 and 20% of [1] - [2]

[4] = [1] - [2] - [3], and [5] = [4] / [1]

As you can see from the results, Co. A is consistently more profitable, but perhaps at the expense of employee stability. While Co. B is more likely to enjoy employee satisfaction, it does so at the price of diminished profitability.

Conclusion

Chosing an appropriate basis for variable compensation can be critical to a company's bottom line. Likewise, such a choice can be vital to its ongoing employment continuity. Unfortunately, the optimal choice for one rarely is the same as the choice for the other, and the real world requires a trade-off between them. Fortunately, for this purpose financial models can be worth their weight in gold, particularly for examining "what if" possibilities. An organization's value - financial capital, human capital, and the trade-off between them - depends on it.

HUMAN CAPITAL: METRICS MATTERS

It seems many HR professionals are "numerically challenged". However, there comes a time when a certain level of quantifying ("metrics") is necessary for the organization to meet its potential. What's more, for HR to find its place at the Board table, it will need to learn what drives its organization.

What's The Problem?

This brings me to my point: metrics matters. Huh? If I've lost you already, let me convey it by way of examples:

- *Layoff vs. Expansion*. Company A contemplates a layoff, but has lauded its employees as its most important asset. If employees turn out to be a net expense, it may be time for a layoff, but if they are seen as an investment, the appropriate response might be to increase business. How should it proceed?
- *Merger / Acquisition*. Business B has an opportunity to acquire another company. HR is involved in due dilligence and spends its time on total compensation and compliance matters, but cannot reach a conclusion about the efficiency of the potential workers. As a consequence of this intangible, management is unsure whether to proceed.
- *Turnover*. Employer C's turnover has become a significant problem, but exit interviews fail to pinpoint a common cause. "Value chain" theory suggests that satisfied workers result in higher retention, resulting in higher customer satisfaction, higher sales, and profits. However, without knowing the cause, making any change might be counterproductive. What about restructuring or outsourcing? Could the problem have been anticipated through an early warning system?

For Example

Just what are we talking about here? Well, for example, consider one of numerous key indicators, Human Capital Return on Investment, commonly defined as:

Revenue minus (Operating Expense minus Total Comp Cost),
divided by Total Comp Cost

In others words, what's left of revenue after removing non-comp expenses, expressed as a percentage of Total Compensation (payroll and benefits). That is pretty straight forward, but is it correct? Maybe or maybe not. It depends on special considerations peculiar to a particular employer. Are there special exceptions that should be adjusted in the formula? Should all revenue be weighted equally? How should bonuses be treated that would distort compensation during some reporting periods? Should the formula be seasonally adjusted? What about adjustments to pay for time not worked? Generally the proficiency of workers doesn't show up in the same reporting period as they are paid, so should the revenue component be used on a lagged basis? And so on.

I'm afraid without assistance that some employers may reach counterproductive conclusions. Other employers will give up altogether, because the results "just don't seem right".

Unintended Consequences

There is a branch of metrics which seems intent on placing a value on an enterprise's human capital. This was particularly acute during the assendency of high tech companies, but even now there are still articles and books being written on the subject of what employees are "worth". For example, Jac Fitz-enz, called the father of human capital benchmarking, contends that he reached a breakthrough methodology for measuring the bottom-line effect of employee performance. However, I believe some employers will use his methods blindly, rather than integrating them into a more dynamic decision-making process.

Instead of "numbers = conclusions", employers need to incorporate metrics as "numbers + experience = decision-making input". That is, metrics is helpful, but complete reliance on it can be harmful to an organization's health. Frankly, I believe this is why many HR professionals are reluctant to use any level of quantification - out of concern that employees will be seen as just another component within the mixture of the company's cost of goods.

What's In It For Me?

Metrics within HR is "new science", which helps explain why some professionals need to be sold on the idea. On the other hand, employers intent on thriving (not just surviving) must begin tracking a number of important work-related measurements. Employers who see beyond "individual worth" to "company performance" will be the ones who reap the rewards of metrics. In this way, not only can organizations improve, but employees can gain as well.

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